

Directorate of
Intelligence

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**Near East and
South Asia Review**

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King Hussein has reacted to the Palestinian uprising in the occupied territories by publicly acknowledging the PLO's enhanced prestige while keeping a tight rein on Palestinian nationalist activity in Jordan. Although the King has lowered his profile in regional peace efforts for the time being, he has not ruled out Jordan's eventual reemergence as a major player in the peace process.

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The PLO's declaration of independence and qualified acceptance of UN Resolutions 242 and 338 last month were spurred by the Palestinian uprising in the occupied territories and pressure from Palestinians there for a more creative PLO strategy. The move is intended to challenge Israel and the United States to support negotiations that would define borders between Israel and a Palestinian state.

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Druze leader Walid Junblatt's Progressive Socialist Party militia, which was forced out of West Beirut in 1987, has reemerged as a key military player as a result of the presidential crisis. Backed by Syria and positioned south of Christian East Beirut, the force will play a prominent role in any military showdown with the Christians.

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Gen. Antoine Lahad is apparently recovering from the serious wounds he received in an attack on his life last month. Even if Lahad is unable to resume his duties, other commanders of the Israeli-supported militia force and its Israeli advisers will probably be able to keep the force functioning.

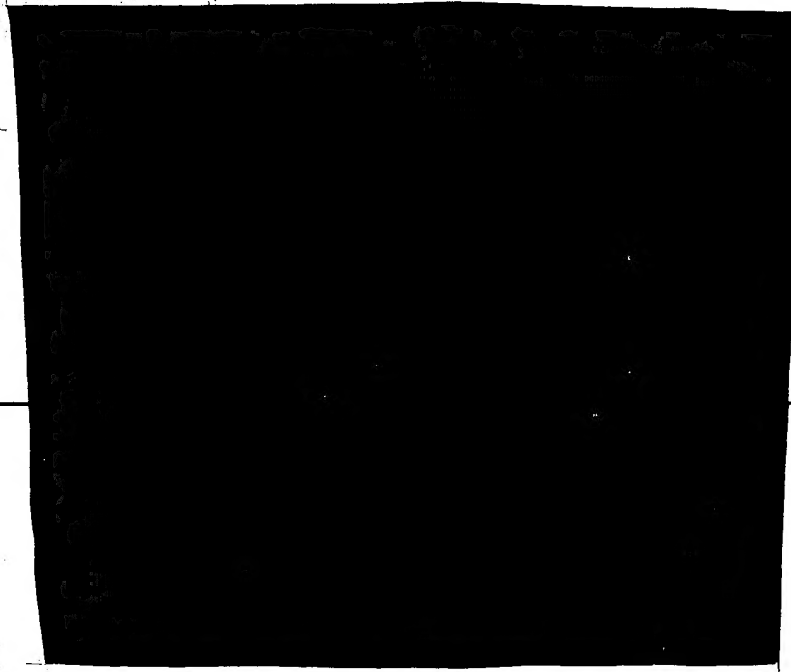
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The outlook for the Algerian economy has become bleaker since the widespread civil unrest of early October. Gross domestic product growth remains stagnant and Algiers is now forced to draw down dwindling foreign exchange reserves for needed food and manufacturing inputs.

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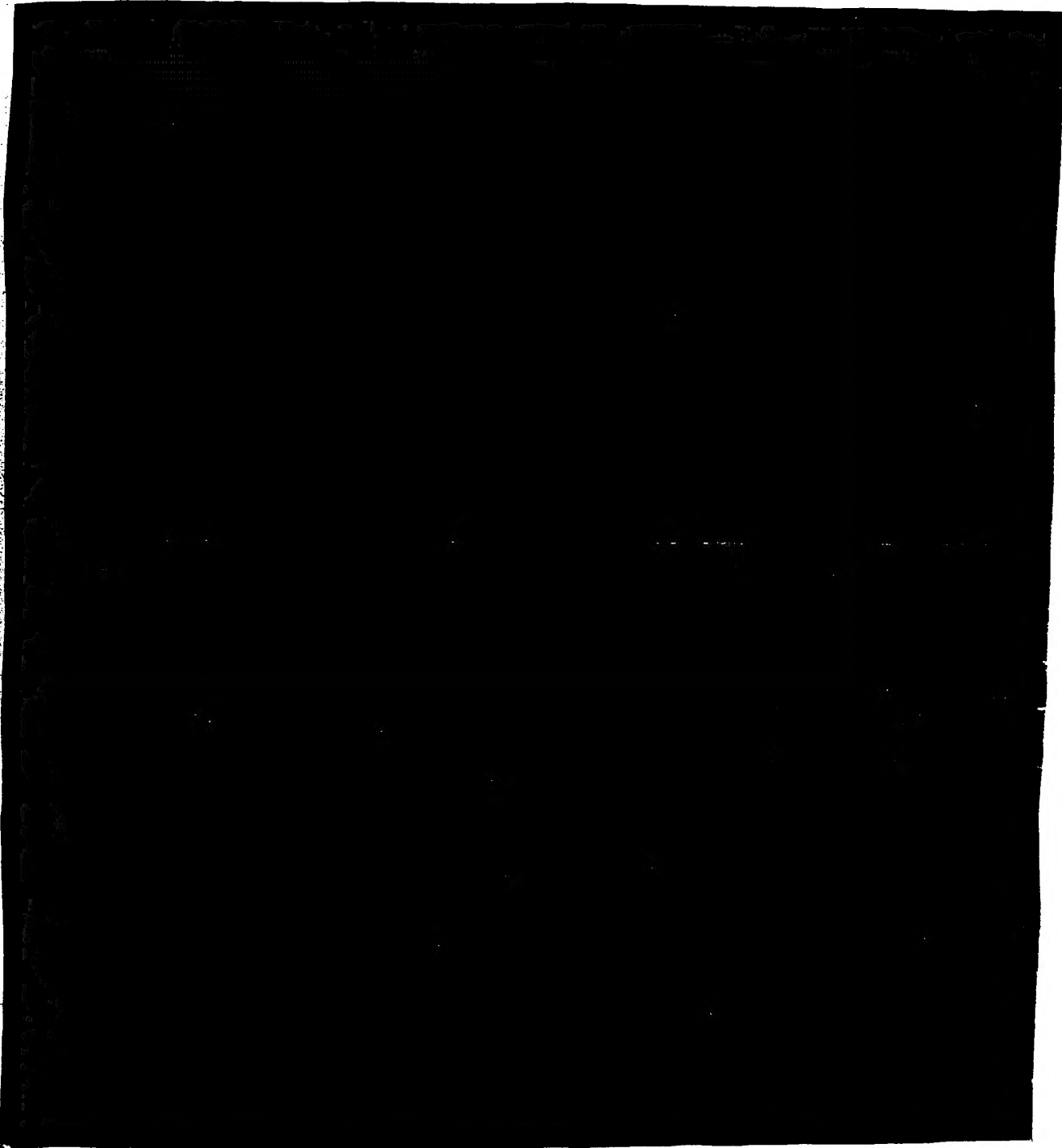


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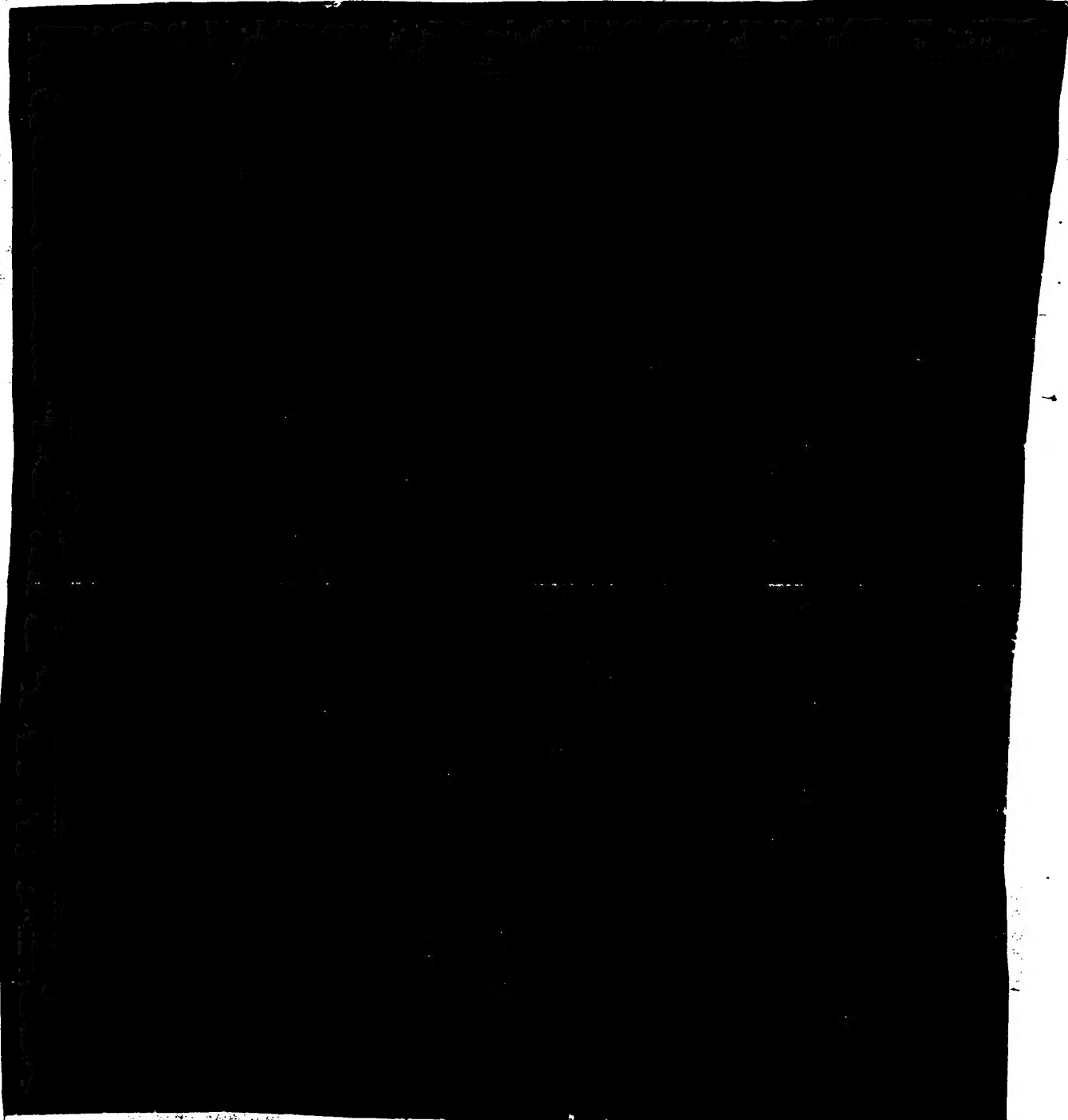
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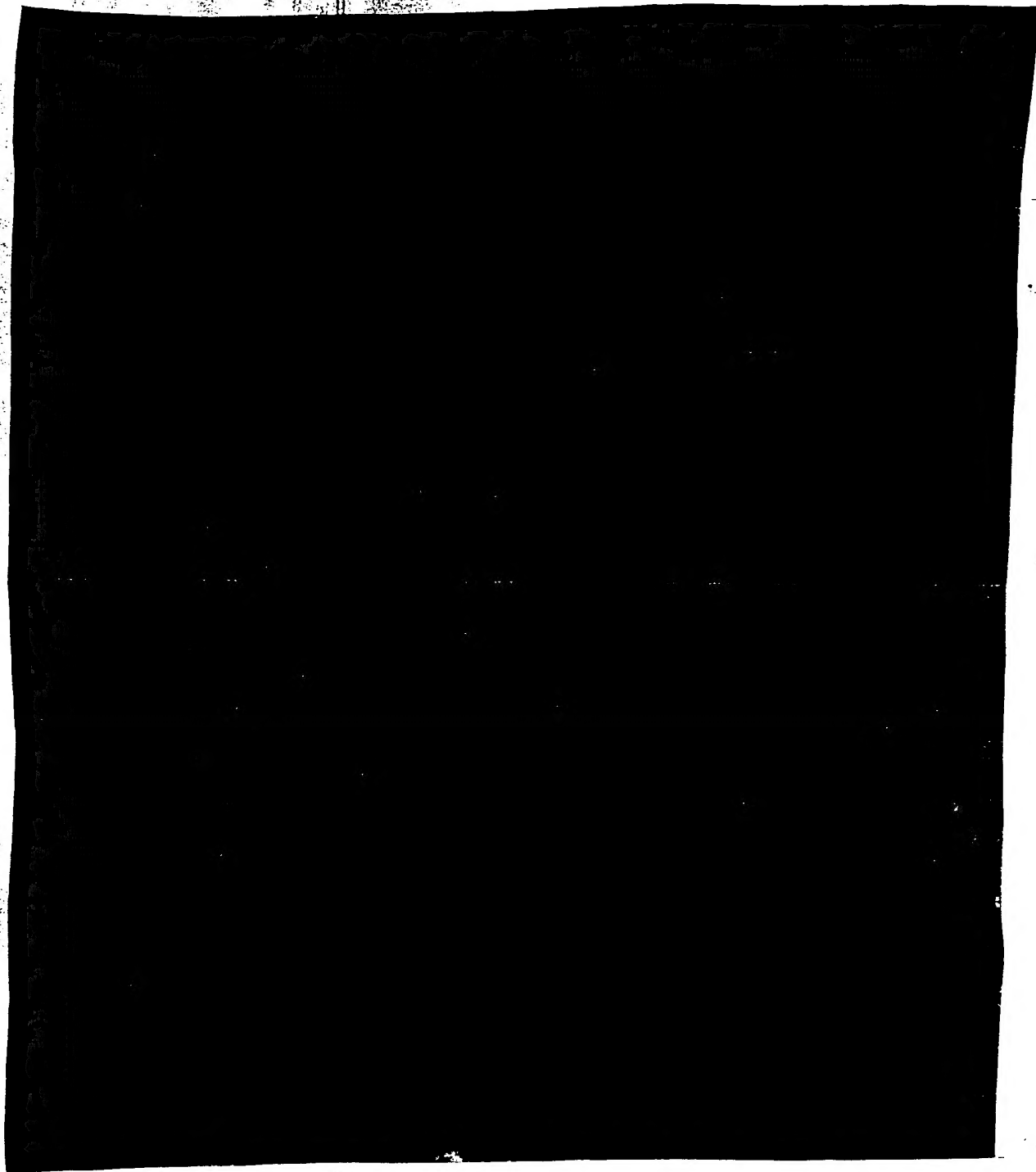
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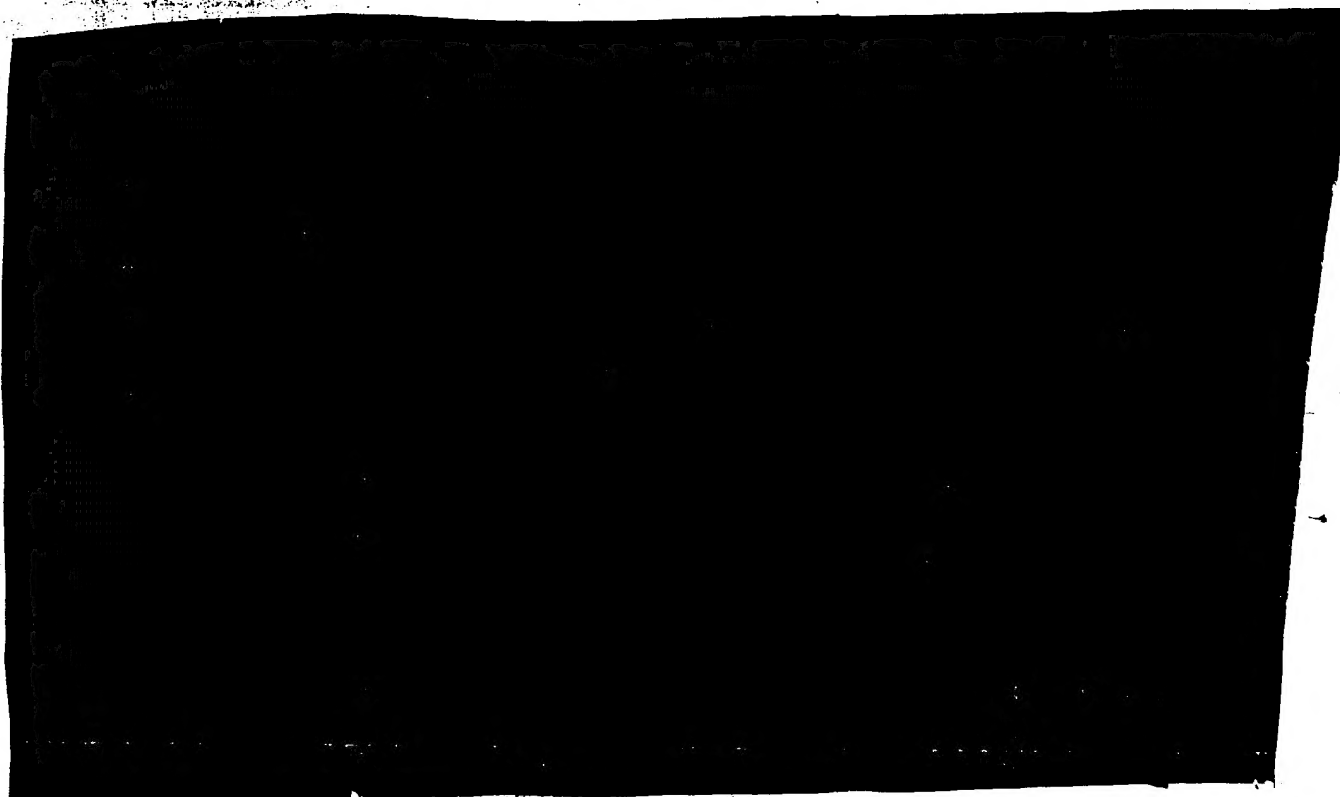
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Informal Economic Activity in Developing Countries

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The informal sector—a component of “hidden” economic activity—plays a significant role in generating employment and income in most developing countries, but some income groups and classes within a given country benefit from it more than others. Although the informal sector and other forms of hidden economic activity do not insulate troubled regimes from the political consequences of inappropriate economic policies, they should, in our view, be carefully considered when assessing the size, strength, and durability of economies as diverse as those of Egypt, Tunisia, and India.

A Closer Look at the Informal Sector

The conventional view of the informal sector has been largely a negative one of clandestine entrepreneurs and street vendors whose businesses are not registered or taxed—thereby depriving the state of the revenues needed to attend to serious social and economic problems. Recently, however, a more positive school of thought has emerged among some development economists who view the informal sector as a spontaneous and creative response to the inability of governments to satisfy basic demands for employment, goods, and services. These theorists also contend that the cost of entering and remaining in a country's formal sector is usually too high for small businesses, making informality the only alternative.

Informal operators keep their businesses deliberately small to remain outside governmental regulation. The quantitative criterion of “smallness” varies according to each country, but normally firms that employ less than 10 workers escape regulatory and statistical notice and, therefore, remain informal.

The informal sector contributes a sizable portion of gross domestic product in many Third World countries:

- Peru's informal sector produced 32 percent of total GDP in 1984
- Indian research economists estimate “unregistered” manufacturing and services in their country at 30 percent of GDP in 1988.
- A 1987 study of the Tunisian economy concluded that GDP is underestimated by at least 20 percent and employment by 25 percent if the contribution of the informal sector is not calculated.
- Egypt's Ministry of Planning estimates the informal segment of the Egyptian economy at 30 percent of GDP.

The image of the informal economy as largely composed of unsophisticated street vendors and shopkeepers is an increasingly inaccurate picture of this dynamic sector. In India, a private economic research institute estimates that there are 1.8 million small-scale industrial units nationwide. Many of these firms produce relatively sophisticated component parts and finished goods—for example, television components and consumer appliances—for larger, formal-sector firms. Studies in Tunisia and Egypt show “informals” also maintaining their dominance in more traditional areas such as woodworking, metalworking, and leather, textile, and clothing production. In Tunisia's case, nearly half of manufacturing employment was found to be concentrated in the informal sector.

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Defining Black, Gray, and Informal Economies

Various types of economic transactions fall under the generic title of the "hidden economy." For the purposes of this analysis, all production, financial flows, and trade that occur without government regulation or control are defined as hidden. There are three major categories of the hidden economy:

- Informal economy. This sector consists of two distinct components—a traditional agricultural sector that bypasses government controls and a small-scale, largely urban-based manufacturing and service sector that also largely escapes government notice. In our view, small-scale manufacturing and services in the informal sector have a dynamic impact on the economies of Third World countries.
- Black economy. Black economic activities comprise production and transactions clearly deemed illegal by government authorities. Included in this category are the smuggling of illegal drugs, weapons, and other goods, as well as prohibited currency transactions. Although some observers argue that even these activities produce substantial

economic benefits for a large segment of Third World populations, we believe their overall economic impact is clearly negative. Even when black money is "laundered" into the formal economy, it tends to feed conspicuous consumption and speculative investment, according to economic development theorists. Such activity generates little productive wealth and fuels social tensions by creating huge disparities in income.

- Gray economy. The gray market is best described as consisting of economic transactions of questionable legal origin that are not explicitly proscribed by authorities. Such activities include some forms of commodity and real estate speculation, the operations of private foreign exchange dealers, and quasi-legal practices of formal sector firms. The gray market is a nebulous area with some transactions shading into the black market and others bordering on the informal sector. Like the black economy, most income generated by the gray market feeds consumption and amounts to little in the way of productive activity.

A large share of informal economic activity in Third World countries is within the service sector.

"Informals" comprise a major share of the residential construction industry, the mechanical repair sector, and a large share of the transportation sector (minibuses and taxis).

In Tunisia, nearly half of service-sector employment is informal. Financial services, particularly the transmittal and investment of expatriate worker earnings in the Middle East and South Asia, are also handled by informals. From Egypt's Islamic investment houses to Pakistan's "Hundi" system

utilizer of scarce capital resources and abundant labor. Studies on developing economies have shown the informal sector to be a highly competitive market in which capital and labor tend to be more efficiently used than in the formal sector, where capital costs are frequently subsidized and the cost of labor pushed higher by government regulation and union pressure. Informals also appear to have a good track record in creating new jobs, distributing income more widely, and enhancing the skill level of the work force.

In most Third World countries, the informal sector comprises a major and growing portion of the job market. In Tunisia, it provides 50 percent of all nonagricultural

Assessing the Role of the Informal Economic Sector
We believe the informal sector plays a significant role in generating employment and income in developing countries. Moreover, it appears to be a more efficient

Why Small-Scale Business Resorts to Informality

Extensive studies done on Peru in the early 1980s

illustrate clearly why many small-scale businessmen in Third World countries resort to informality. Their colleagues attempted to comply with all government regulations and licensing procedures during the fictitious registration of various business activities. It should be noted that during the period of the study, per capita income averaged less than \$1,500 per year in Peru. Their research revealed that:

- To register a small company required multiple approvals, many of which necessitated bribes, took 289 days, and cost \$1,231.
- To petition the government for a piece of vacant land on which to build a house required almost seven years of bureaucratic redtape and cost \$2,156.
- To obtain approval to open a small store required 43 days of redtape and cost \$590.

employment. The ability of informal businesses to set up without delays because of red tape also leads to a more rapid growth rate than in the formal sector. In India, for example, studies show that the informal sector has consistently outpaced the large-scale modern sector in creating new jobs over the past 10 years, a trend likely to continue into the 1990s.

Nevertheless, most economic theorists believe informal economic activity still represents a suboptimal use of economic resources. Because they are not officially recognized, informal firms lack access to formal lending institutions, which usually charge far lower rates of interest—50 percent or less—than informal lenders. Informal enterprises also do not enjoy the protection of contract rights and cannot take advantage of limited liability available to corporations. The combination of these factors inhibits the growth of informal firms and prevents them from realizing economies of scale.

The desirability, in many cases, the necessity of avoiding government regulation also encourages suboptimal economic performance in the informal

sector. In Egypt, for example, firms employing over 10 workers have difficulty escaping government scrutiny, leading many informal operators to split and form separate firms to avoid official notice.

Political Implications

Informal economic activity, in our view, plays a significant role in maintaining political stability in many Third World countries. The sector provides a "cushion" that helps insulate large segments of the population from the frequently lackluster performance of the government-controlled formal sector. During periods of austerity and uncertainty, the cushioning role of informal activity appears even more important. We may, in fact, be seriously underestimating the capability of developing societies to endure indifferent or adverse economic performance if we measure only the performance of the government-controlled portion of the economy.

If gray and black market economic activity is also factored into the income and employment equation, it is conceivable, in our opinion, that an economy can stumble along for many years, generating enough "hidden" economic wealth to prevent an unacceptable decline in living standards. Egypt and Tunisia are probably good examples of economies that have been carried along by the strength of unrecorded and informal activity.

strongly suggests that some socio-economic groups in Third World countries benefit more than others from the informal economy. Some of the lower strata of these societies—rural populations and, in particular, recently arrived urban migrants—appear to comprise a disproportionate share of workers in the informal economy. These groups have traditionally benefited little from government assistance and are the least likely elements of the population to place demands on a regime for economic intervention.

The urban lower middle class—composed mostly of government workers and public-sector employees—does not appear to benefit as much from informal economic activity in many countries. Although many

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in this group reportedly engage in moonlighting and participate in other informal and gray market activities; they generally remain expectant and dependent on government wages, subsidies, and price controls. We believe it is from within this politically important group—along with the unemployed, nontechnically educated younger generation—that economic frustration breeds trouble for a regime. A government's long-term survival would appear to still rest upon its capacity to generate sufficient wealth in the formal sector of the economy to satisfy these elements of the population.

Future Considerations

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Already, many of the reforms being promoted under economic liberalization—streamlining licensing procedures, deregulating interest rates, and eliminating price controls—are consistent with the goal of stimulating private-sector development, including the informal sector.

A recurring theme among Third World countries, however, is the effort by cash-starved regimes to tap the wealth generated in the informal sector without

providing sufficient incentives. Such efforts usually include cracking down on private foreign exchange dealers and small shopkeepers. These policies invariably fail, as informals move or alter their operations enough to evade government control—usually at a high cost to the overall economy in productivity and income generation.

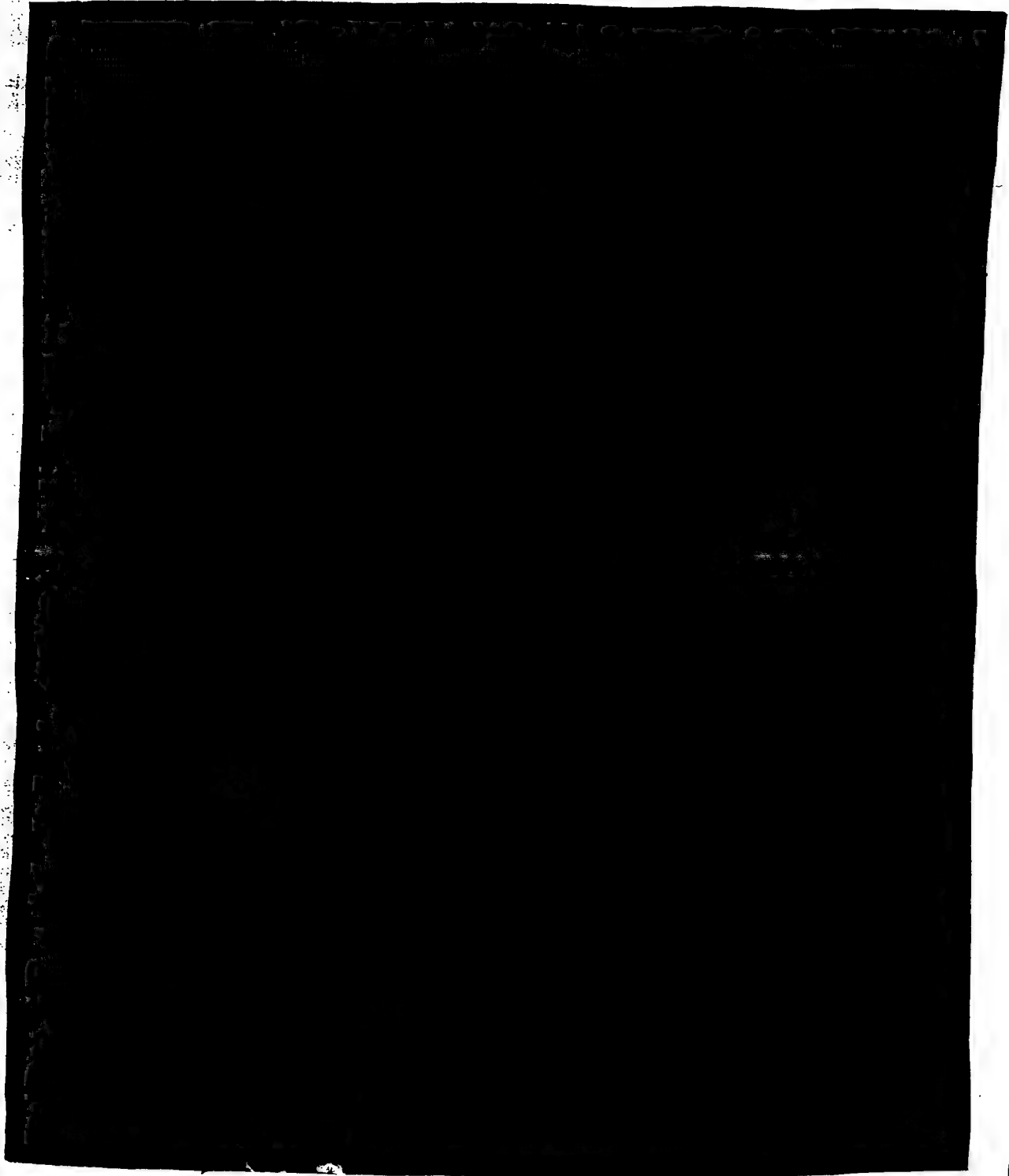
Efforts to integrate the small-scale and informal sector into development programs—as well as more general progress in economic liberalization—will likely face a constant barrage of short-term exploitive tendencies by regimes concerned with near-term survival. Progress will also not be easy in the face of likely continuing political opposition from those in government and formal-sector companies, public and private, who benefit from existing preferential legal and financial treatment.

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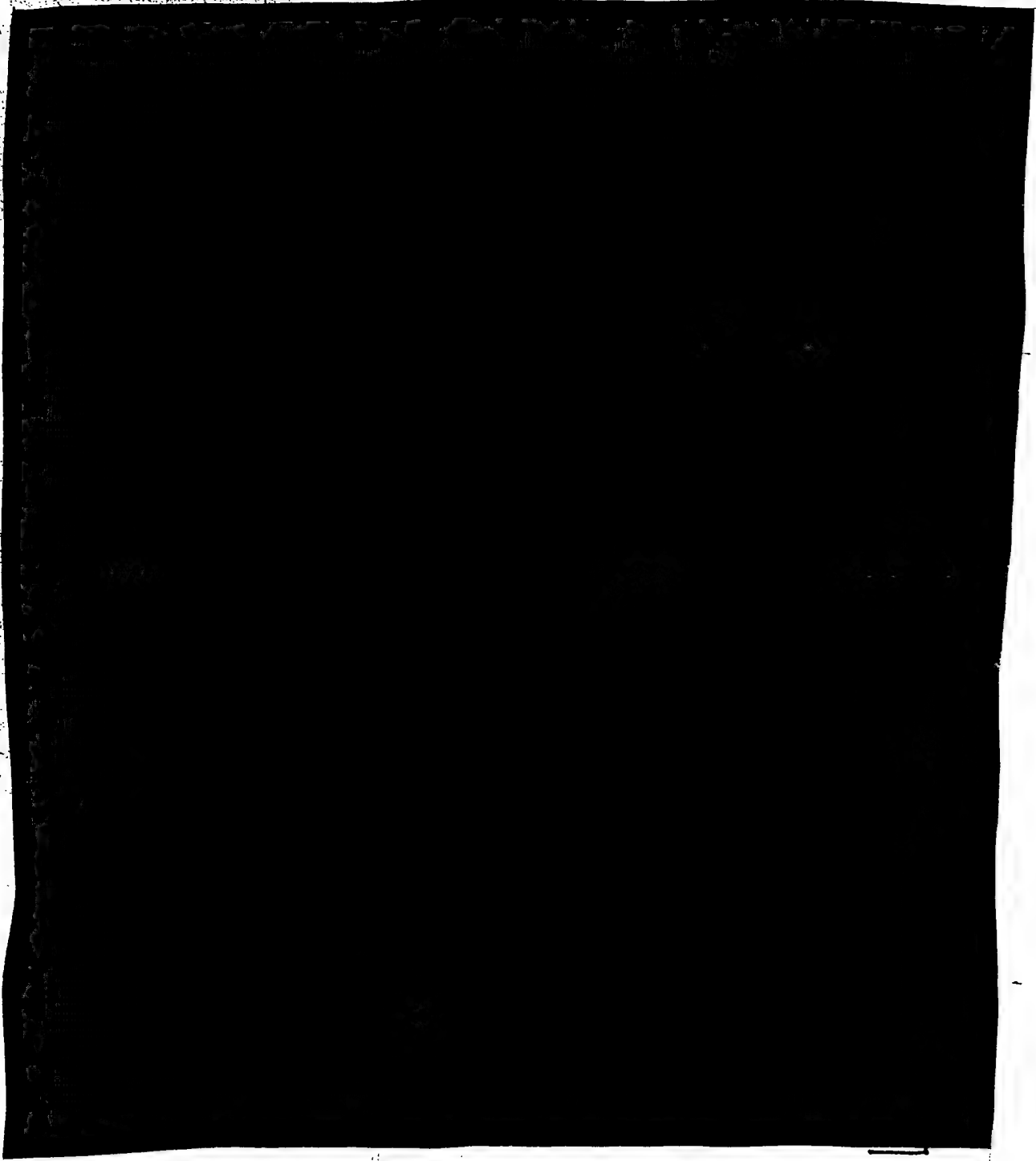


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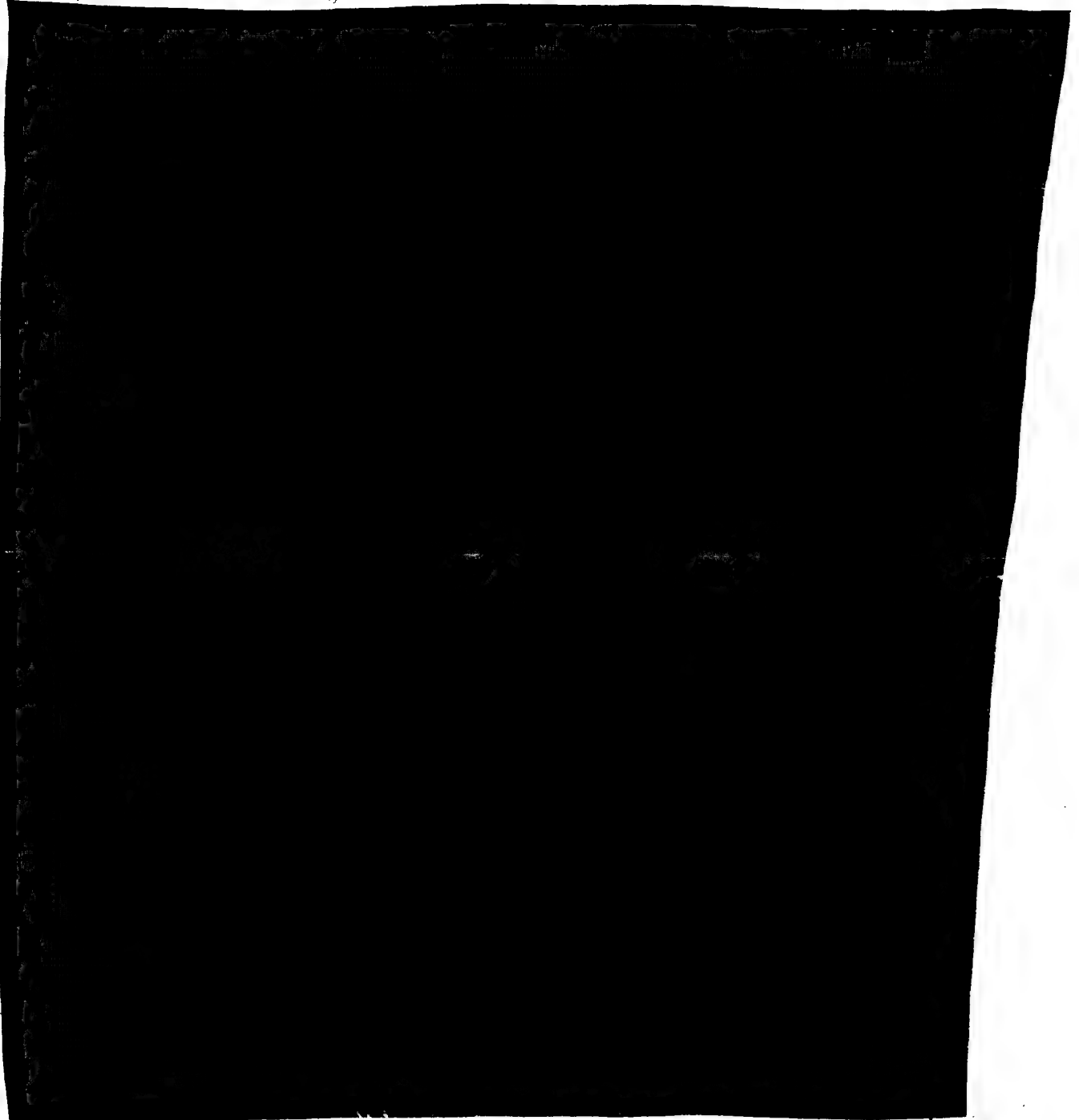
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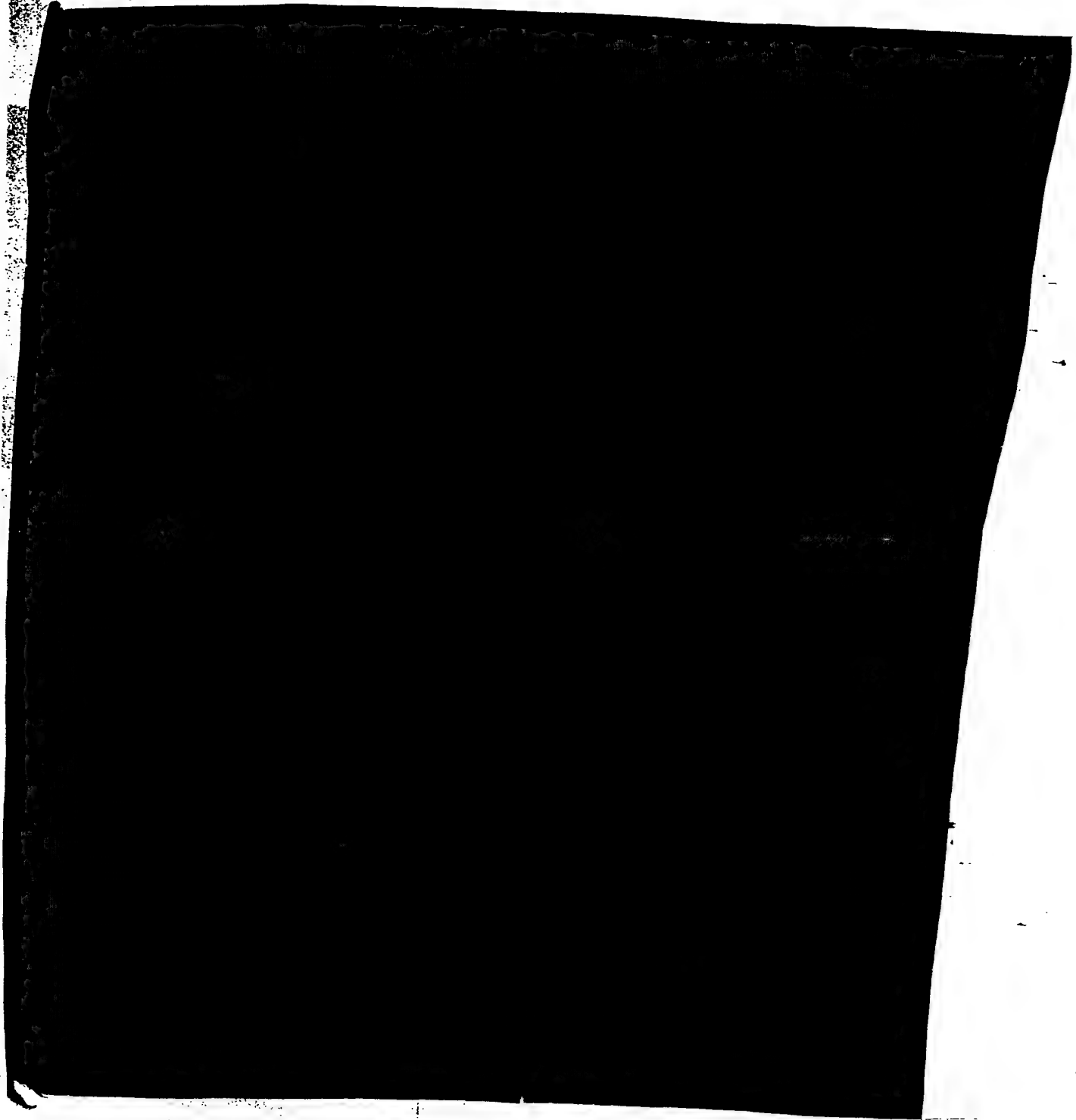
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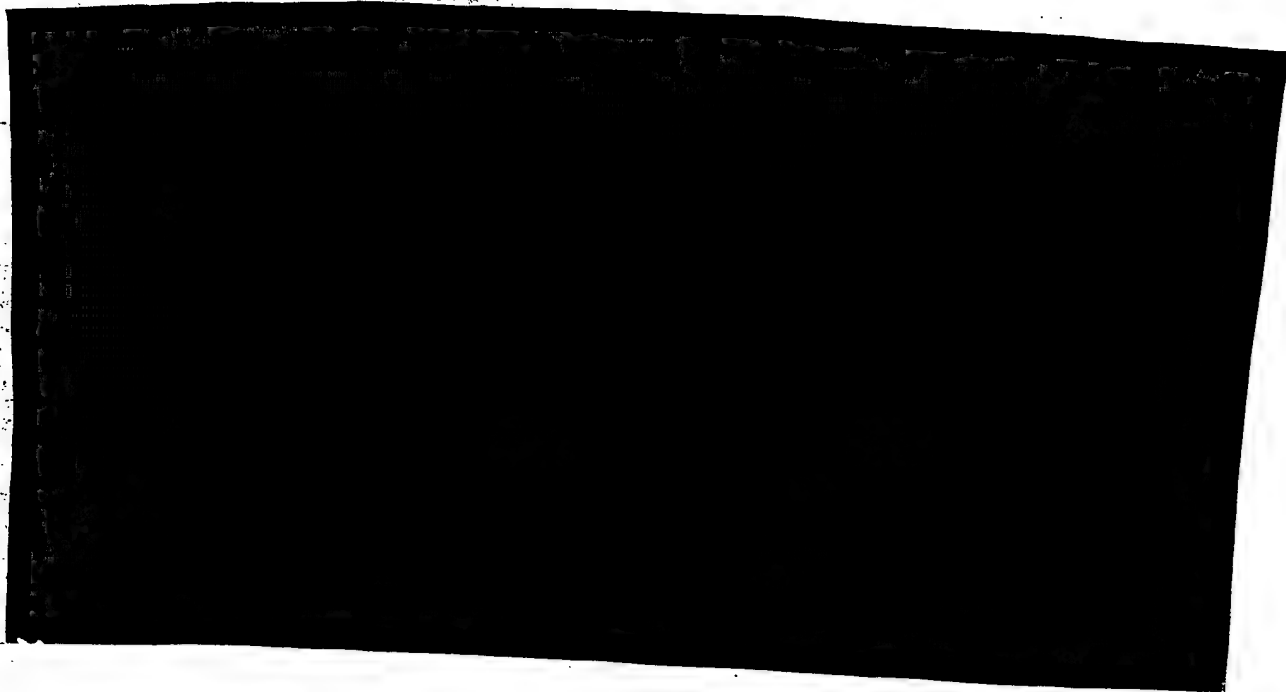


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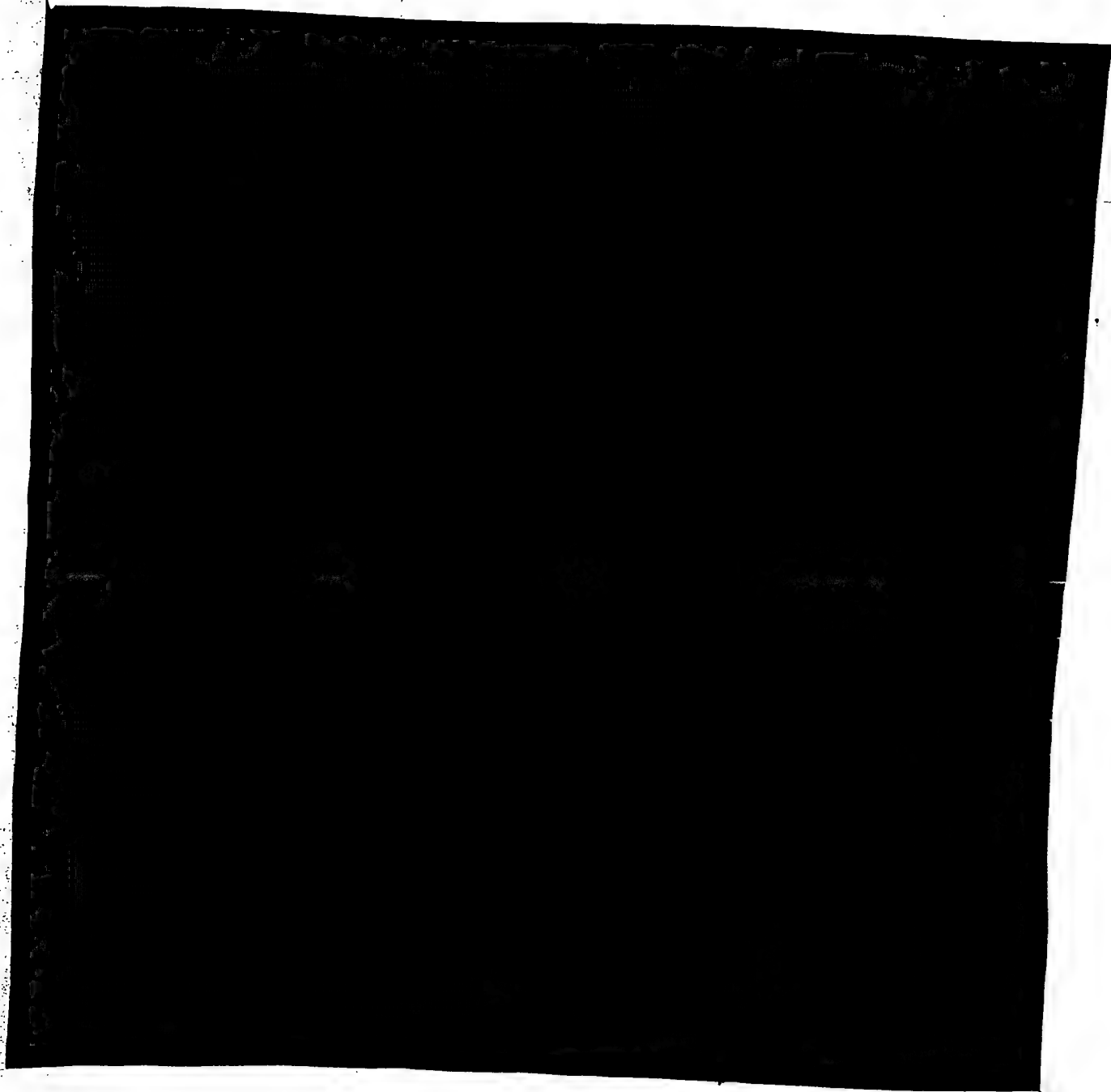


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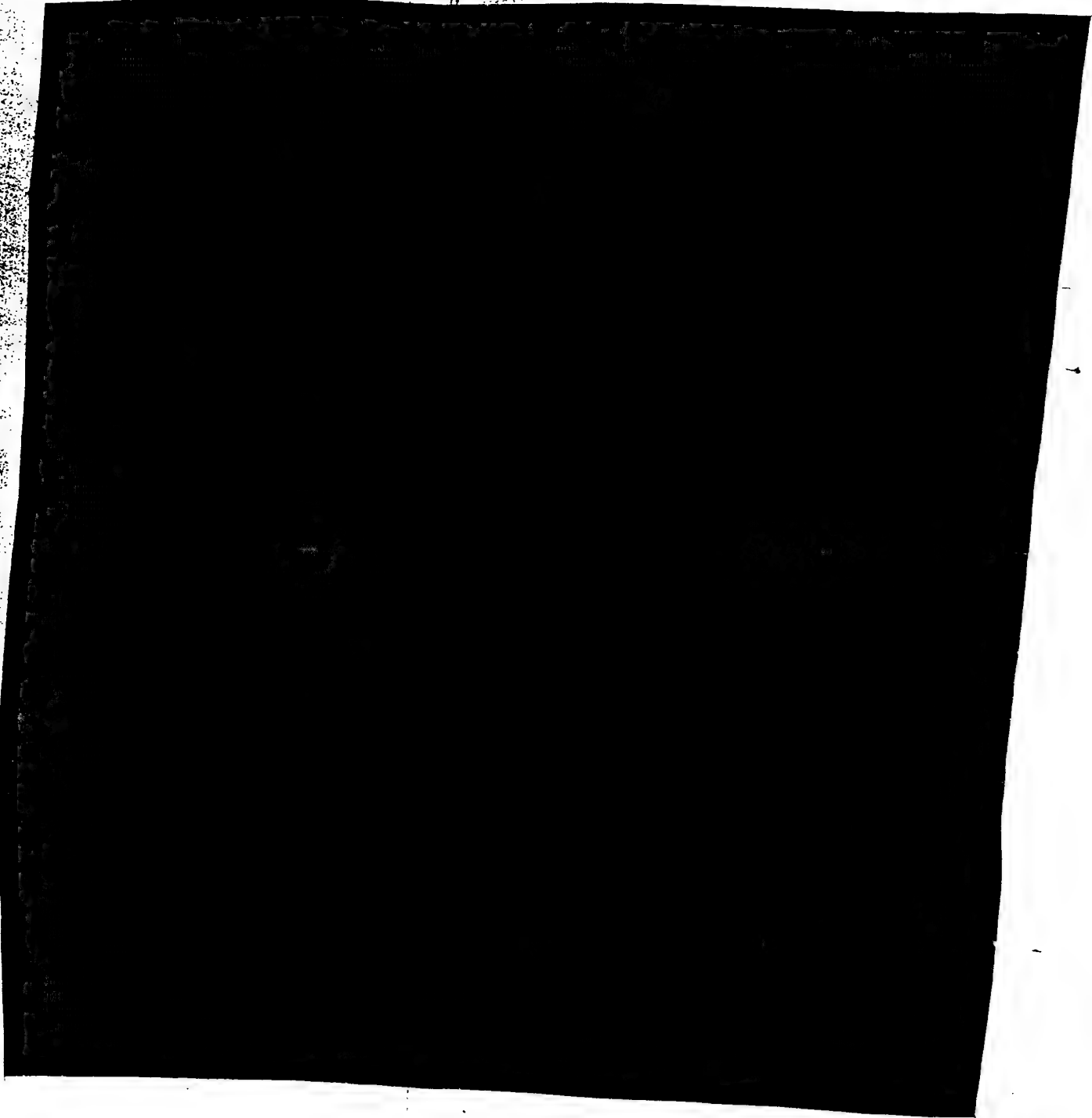


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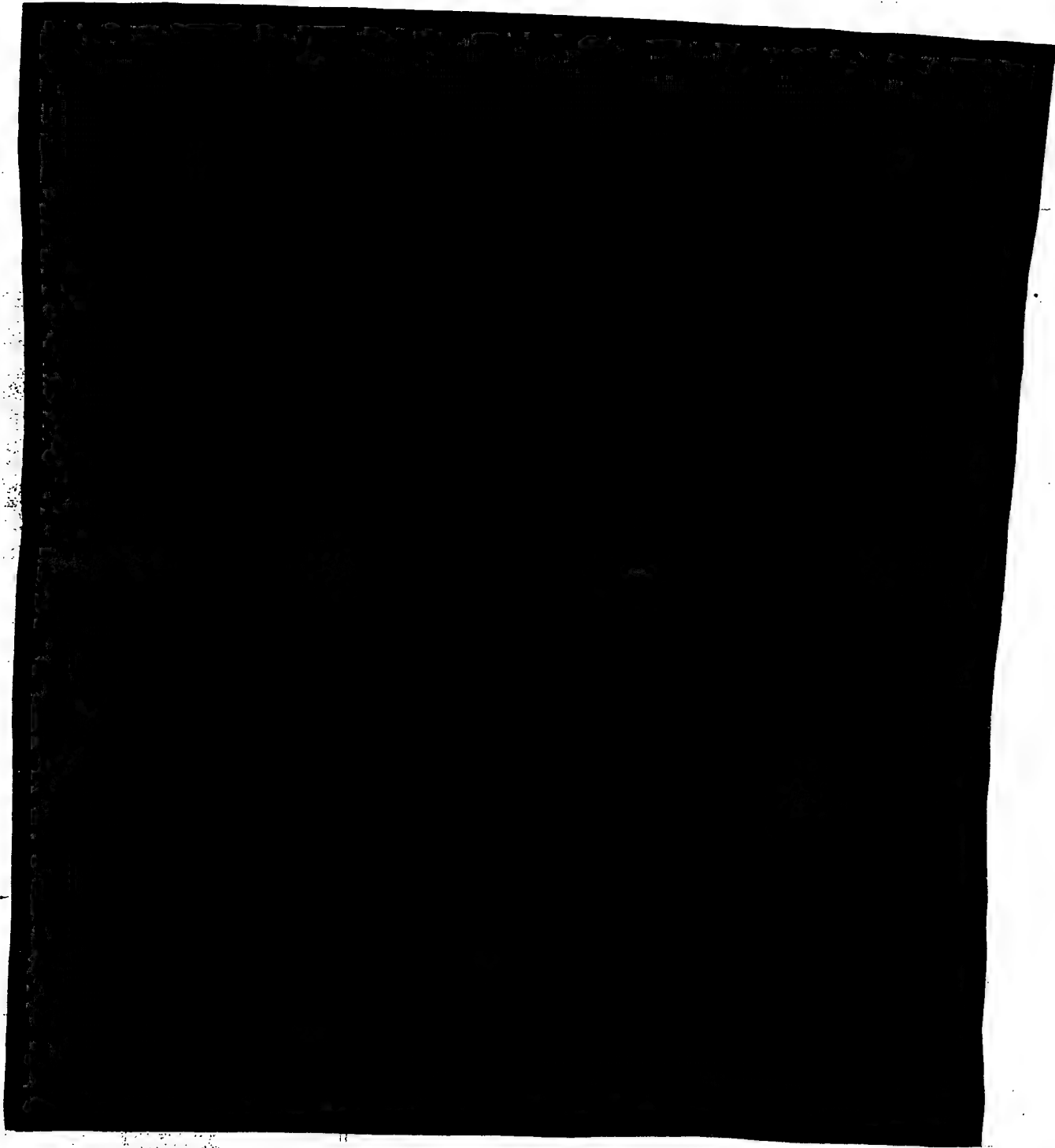
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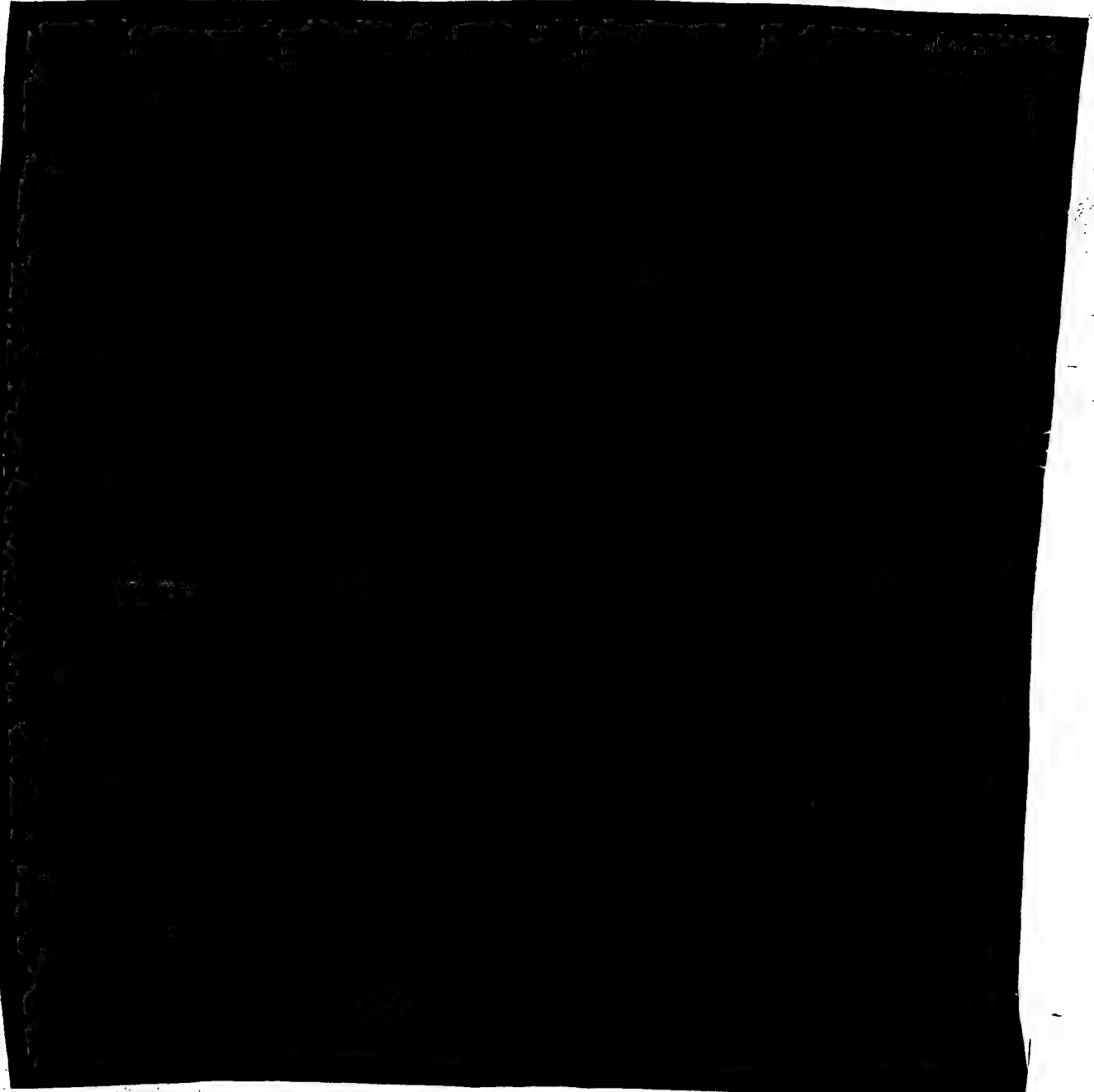


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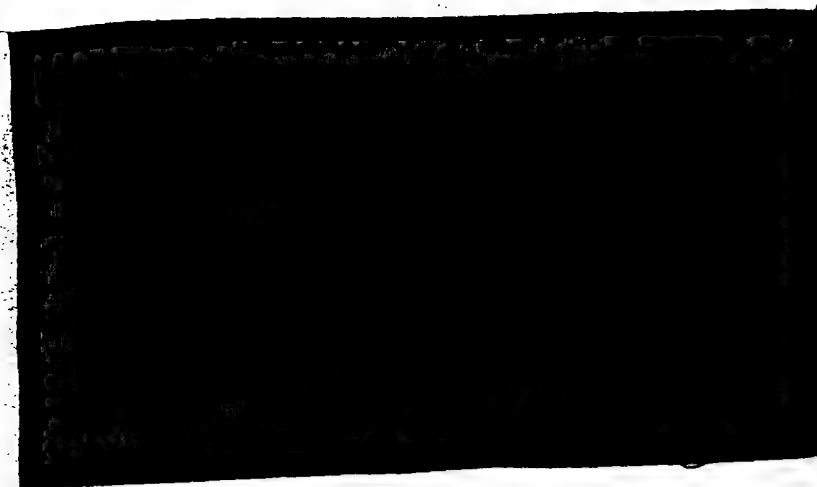
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Jordan and the Intifada: Battening Down the Hatches

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Jordan has moved quickly to protect itself from a spillover of Palestinian unrest from the uprising in the West Bank and Gaza Strip by acknowledging publicly the enhanced prestige of the Palestine Liberation Organization (PLO) while keeping a tight grip on Palestinian nationalist activity in Jordan.

[redacted] have not ruled out Jordan's eventual reemergence as a major player in the peace process. The development of a young, activist local leadership of the intifada will probably not force Hussein to modify his long-term strategy of gaining influence over the PLO and Chairman Yasir Arafat, who is still unrivaled as the symbolic leader of the Palestinians. Unless violence escalates dramatically in the West Bank, Hussein will likely be able, by combining pro-PLO gestures and tight security, to hold Palestinian nationalism in Jordan in check for at least the next several months. b3

Jordanian Concerns

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The outbreak of the intifada in December 1987 once again placed Palestinian issues at the forefront of Jordan's domestic and foreign policy concerns. We estimate [redacted]

[redacted] that slightly more than half of Jordan's 2.8 million people are Palestinians and that more than 850,000 of the Palestinians in Jordan are registered as refugees with the United Nations. More than 200,000 of these refugees live in 10 camps in Jordan. This demographic mix and Jordan's long border with Israel oblige Hussein to walk a delicate line between respecting Palestinian national aspirations and dampening these aspirations to appease Israel. The intifada's nationalist origins and goals, in our view, have served as a daily reminder to Hussein of this fundamental national dilemma. (S)

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In addition, the intifada has raised new strategic challenges for Hussein. [redacted] the PLO, young street organizers, and Islamic fundamentalists are all attempting to assert

their leadership of the uprising. Although Arafat commands by far the greatest following among West Bank Palestinians, the possibility that an indigenous, less predictable, and less pliable Palestinian leadership may emerge has complicated Hussein's long-term bid to defuse Palestinian nationalism by reaching a negotiated settlement on the status of the West Bank. The intifada has also hardened Israeli attitudes toward such a settlement, forcing Hussein to develop other diplomatic assets—including ties to the Soviet Union—to push for peace talks and avert a drift toward Israeli and Palestinian extremism. b3

Jordanian Response

Hussein's political response to the intifada has been to reduce Jordan's West Bank role and defer for the time being to the PLO, given its improved international standing. The King's decision last July to sever administrative and legal ties to the West Bank challenged an ill-prepared PLO to assume the costs of schools, hospitals, and government services previously provided by Amman. Nonetheless, by couching his pullback in terms of a formal recognition of the PLO as the sole legitimate representative of Palestinians, Hussein—in our view, joined an increasingly strong pre-PLO consensus in the Arab world and signaled his own Palestinians he did not seek to betray their nationalist aspirations. [redacted] b3
even Hussein's native Bedouin constituency was pleased by the move for its implicit retreat from a potentially risky foreign policy and its sign that Hussein would focus more on domestic concerns. b3

The retrenchment, however, has probably given Hussein long-term tactical leverage with Arafat. b1, b3

[redacted] eventually will encourage Arafat to recognize and seek out a Jordanian role in a

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peace settlement. The October meeting between Hussein and Arafat in Jordan's port city of Aqaba and Arafat's subsequent declaration at the Palestine National Council meeting of PLO willingness to confederate with Jordan suggest a rapprochement between the two leaders, led by Arafat, has already begun. The Aqaba meeting is the clearest indication yet that Hussein has the ability to bolster his pro-PLO Arab credentials rhetorically without sacrificing his strategic goal of dominating the PLO.

Outlook

Hussein is likely to retain a low profile in regional diplomacy, awaiting the full international reaction to the Palestine National Council's declaration of an independent state and indirect recognition of Israel. Hussein's decision to accord Jordanian recognition to the declared Palestinian state suggests he intends for the time being to defer to Arafat to preclude any Arab or Palestinian accusations that Jordan has not fully supported the PLO.

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A failure of the PLO to engage the United States in a dialogue on peace issues might speed Hussein's return to higher profile diplomatic efforts. A PLO diplomatic setback would likely fuel a new round of internal PLO bickering, disappoint West Bank Palestinians, and eventually reaffirm the importance of Jordan in any regional peace efforts. Hussein's rhetorical support for the PLO suggests he has no intention of accelerating any possible PLO failure, but his own interest in playing a prominent role in a peace conference suggests he will be receptive to any PLO invitation to reenter more openly regional diplomatic efforts.

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The intifada's success in forcing Hussein to pull back for the time being from high-profile peace diplomacy has not slowed Hussein's drive for new diplomatic ties and long-term leverage in the peace process. During the past year, Hussein continued to expand ties with Moscow, sought political support in Western Europe for an international peace conference, and continued to explore closer relations with China.

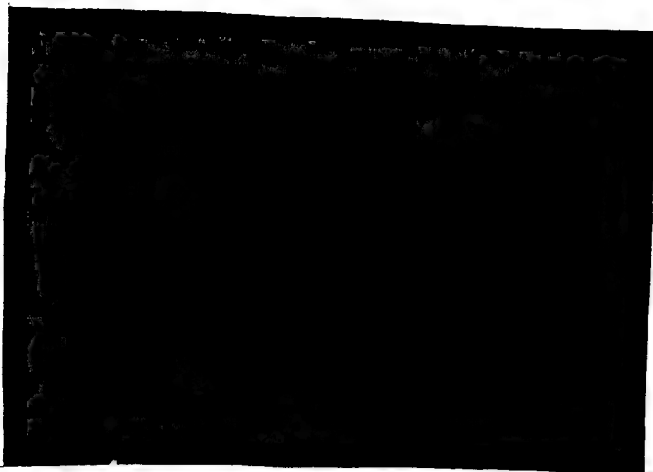
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Current levels of Palestinian unrest in the West Bank, in our view, are not likely to provoke instability in Jordan soon. We believe Hussein's strategy of bowing publicly to the PLO while keeping a tight grip on Palestinian unrest in Jordan has proven effective and will serve as a model for future Jordanian policy on the intifada. Nonetheless, Hussein probably calculates the emergence of a hardline government in Israel would lead to increased unrest in the West Bank in the short term, requiring even firmer measures against Palestinian activists in Jordan to prevent a spillover of unrest. Even if violence escalates, Hussein will be reluctant to reverse his public position on support for the PLO as the legitimate representative of Palestinians.

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**The PLO and the Intifada:
Evolving Political Strategy** b3

The Palestine Liberation Organization's (PLO) symbolic declaration of independence and qualified acceptance of UN Resolutions 242 and 338 last month were spurred by the Palestinian uprising in the West Bank and Gaza Strip and pressure from more pragmatic Palestinians there for a more creative PLO strategy for dealing with Israel. PLO leaders and their supporters in the occupied territories see these decisions taken at the Palestine National Council (PNC) meeting in Algiers as radical departures from existing policy that demonstrate the PLO's new willingness to recognize and negotiate with Israel. The PLO's move is intended to challenge Israel and the United States to support negotiations that would define borders and relations between Israel and an already declared Palestinian state. PLO Chairman Arafat must weigh the political gains of more explicitly recognizing Israel against the dangers of rupturing the PLO's fragile unity built on the allegiance of the more hardline factions. b3

The PLO, Palestinians, and the Intifada

The Intifada inaugurated a new phase in relations between Palestinians in the West Bank and Gaza and the external PLO leadership. The increased politicization of Palestinian youth—demonstrated by the spontaneity, intensity, and scope of their protests—dramatically underscores their dissatisfaction with the tactics used by the PLO leadership abroad to address the Palestinian issue. Many Palestinians in the occupied territories believe the PLO is neither responsive to nor representative of their aspirations. By seizing the initiative, West Bankers and Gazans have increased their political weight and legitimized their role within the Palestinian nationalist movement. b3

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early in the uprising, West Bankers and Gazans began to press the PLO leadership to translate the unity and confidence generated by the Intifada into an effective political program. The more pragmatic West Bankers and Gazans urged Arafat to adopt a

"realistic" approach involving mutual recognition and negotiations between Palestinians and Israel. The idea of a Palestinian declaration of independence and government-in-exile, which had been discussed for many years, was proposed by many Palestinians as an appropriate peace strategy. Arafat probably was concerned that the local Palestinians might launch their own peace initiative and challenge his authority if he resisted their pressure. b3

The Political Legacy

The declaration of independence and acceptance of Resolutions 242 and 338 with qualifications are the latest moderating changes in PLO policy—as stated in resolutions of the PNC—since the National Council first convened in 1964. The founding Charter of the PLO contains uncompromising demands for the "total liberation of Palestine," ruling out the continuing existence of Israel. PLO moderates claim subsequent resolutions of the PNC have modified the maximalist provisions of the Charter and provide a more accurate guide to PLO intentions. b3

The original Charter makes no reference to an independent Palestinian state. According to the Charter, the battle of "liberation" is an Arab struggle—not specifically Palestinian—and Palestine will not be an independent, sovereign state but will be included in a larger Arab grouping. b3

Between 1967 and 1969, Yasir Arafat's Fatah group pushed the PLO to adopt a new strategy favoring an independent Palestinian struggle and the establishment of a "secular democratic state" in all of Palestine. This change in strategy coincided with Arafat's maneuvering to seize control of the leadership of the PLO, which he accomplished at the February 1969 PNC meeting. Fatah has dominated the movement ever since. b3

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PLO Consensus in the Late 1960s

- *Armed struggle is the "only way leading to the liberation of Palestine."*
- *There can be no negotiated solutions, including on the basis of UN Resolution 242 and the US peace initiative of December 1969 known as the Rogers Plan.*
- *A democratic and secular state in Palestine is the Palestinians' strategic objective.*
- *The liberation of the whole of Palestine is the necessary condition for the establishment of a democratic state and there can be no compromises and no accommodation with Israel.*
- *A Palestinian "rump state" in part of Palestine—particularly in the West Bank and Gaza Strip—is not an acceptable solution.*

The changing nature of PLO policy was reflected in amendments to the Charter that were adopted at the fourth PNC meeting, which met in Cairo in July 1968. The most significant change affirmed the role of "armed struggle" as the "only way to liberate Palestine" and linked it for the first time to Palestinian self-determination and sovereignty over Palestine. The revised Charter of 1968 still makes no reference to a Palestinian state. The first mention of an entity by the PLO is contained in the resolutions adopted at the sixth PNC meeting held in September 1969. b3

1974 Debate Causes Split

So long as the PLO and its major Arab patrons were actively confronting Israel, there was little pressure on the PLO's component groups to abandon the maximalist demands contained in the Charter. This situation began to change as early as November 1967 when, following the Six Day War, the UN Security Council adopted Resolution 242 implicitly recognizing Israel's right to exist. The resolution was accepted by Egypt and most other Arab states. The PLO, however, rejected it, arguing at the time that it treated the Palestinian issue solely as a refugee rather than a political problem. b3

To many Palestinians, diplomatic moves in the aftermath of the 1973 Arab-Israeli war raised the likelihood of the Arab states' readiness to make a deal with Israel at the Palestinians' expense. The PLO thus faced the question of whether to participate in a proposed Geneva conference along with the United States, the Soviet Union, Syria, Egypt, and Israel. The implication of face-to-face negotiations with Israel and the resultant de facto recognition of Tel Aviv was inescapable for PLO leaders and was the main subject of discussion at the PNC session in Cairo in June 1974. b3

After considerable debate between moderates who wanted to go to Geneva and radicals who did not, the National Council adopted a resolution known as the Phased Political Program. The resolution—based on the "national authority" program proposed by the Democratic Front for the Liberation of Palestine (DFLP)—rejected negotiations based on UN Resolution 242 and called for the establishment of a "combatant national authority" on any land vacated by Israel. In this manner, the PLO gave qualified support to the notion of a Palestinian ministate in the West Bank and Gaza. b3

The program deliberately left vague the exact Palestinian terms for a settlement and suggested strongly that the PLO intended to continue the effort to eliminate a Jewish-dominated state. The radical Popular Front for the Liberation of Palestine (PFLP) nevertheless rejected the idea of attending a Geneva conference or negotiations with Israel and resigned from the PLO Executive Committee. It formed a loosely organized bloc known as the Rejection Front together with the PFLP-General Command, the Arab Liberation Front, and the Popular Struggle Front. b3

Further Changes in PLO Policy

The PLO's position on Arab-Israeli negotiations was modified slightly at the 13th National Council meeting in March 1977. The 1974 declaration regarding a national authority was changed, dropping the word "combatant" and substituting the word

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"state" for "authority." The new wording asserted the Palestinians' right "to establish their independent national state on their own land." The declaration also stated the PLO's right to participate in any international conference bearing on the Palestinian issue. b3

These resolutions were victories for Arafat insofar as they reaffirmed the Executive Committee's mandate to pursue its existing diplomatic strategy. But they did not come without costs. The radicals inside Fatah and the PLO forced Arafat to drop a proposed resolution calling for coordination between Jordan and the PLO. Arafat had met with King Hussein in Cairo just prior to the PNC meeting in their first public meeting since Arafat's fighters were expelled from Jordan following the civil war of 1970-71. b3

The 14th PNC meeting took place in Damascus in January 1979 and predictably denounced the Camp David accords. The session reaffirmed the PLO's rejection of UN Resolution 242 but softened some of the language from the 1977 formulation. It deleted the phrase stating that the PLO rejects all dealings on the basis of Resolution 242 and another calling for recovery of Palestinian national rights "without reconciliation or recognition (of Israel)." The new language was designed to portray the PLO as willing to consider reasonable compromise. The Council also endorsed a PLO dialogue with Jordan as long as King Hussein did not participate in the Camp David process and did not interfere with the allocation of funds to the PLO agreed upon at the 1978 Arab summit in Baghdad. b3

There was a little change in the PLO's policy at the 15th PNC of April 1981. Despite opposition from radical PLO elements and from Syria, Arafat narrowly secured approval of PLO contacts with the European Community. The Council also endorsed the continuation of the Jordanian-PLO Joint Committee established in 1979 to oversee the distribution of Arab aid funds to the West Bank. b3

The 1983 PNC meeting -- the first session following the Israeli invasion of Lebanon and expulsion of Arafat and his fighters from Beirut -- affirmed a "special relationship" between the Jordanians and

Palestinians and approved the concept of eventual confederation between Jordan and a Palestinian state. The Council resolution said the PLO "refused to accept" the US peace initiative of September 1982 as a basis for a Middle East solution because it did not recognize the PLO or provide for an independent Palestinian state. b3

This language was intended to leave open the possibility of PLO cooperation with the US plan if its perceived defects were corrected. Radical PLO factions insisted that the resolution's intent was to foreclose any PLO involvement with the initiative. b3

The PLO's relationship with Jordan was the focus of the PNC session held in Amman in November 1984. The meeting approved intensified consultations with Jordan aimed at agreement on a joint policy on peace negotiations with Israel. It also affirmed PLO support for an international peace conference as the appropriate forum for peace talks and reiterated PLO demands for an independent Palestinian state and the "right of return" to Palestine for all Palestinians. b3

The 18th PNC meeting, held in Algiers in 1987 and called the "unity" session because of the reintegration of the radical Popular and Democratic Fronts into the PLO, signaled the PLO's reversion to a more hardline policy. The meeting abrogated the Amman accord of 11 February 1985, which had served as the basis for PLO-Jordanian coordination on the peace process. It also reaffirmed the PLO's rejection of UN Resolutions 242 and 338 and the Camp David accords, and its support for an international conference under UN auspices that the PLO would attend on an equal basis with other participants. b3

The November 1988 PNC Meeting

Arafat convened an extraordinary 19th National Council meeting in Algiers last month in response to demands from moderates in the PLO and in the West Bank and Gaza to change PLO policy in the hope of gaining a role in peace negotiations. The debate at the meeting focused on what changes in policy should be

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made and whether a provisional or exile Palestinian government should be created to accompany those changes. Unequivocal acceptance of UN Resolutions 242 and 338 was not a core element in the debate as no faction endorsed this option. 63

The Council agreed to two changes in PLO policy:

- An independent Palestinian state was declared based on UN General Assembly Resolution 181 of 1947, which called for the partitioning of British-ruled Palestine into a Jewish and an Arab state.
- UN Resolutions 242 and 338 were accepted with the qualification that they serve as the basis of an international peace conference together with all other UN resolutions regarding the Palestinian issue.

The Council also reaffirmed Arafat's ban on terrorism outside Israel and the occupied territories as contained in his Cairo Declaration of 7 November 1985—but sanctioned the continued "armed struggle" against Israel. In addition, the PLO endorsed the principle of confederation between a Palestinian state and Jordan, thus returning to its 1983 position. 63

Arafat's Balancing Act

Whenever Arafat has contemplated moderating PLO policy, he has had to weigh the expected diplomatic gain from such changes against the likely damage to PLO unity that would result. This dilemma was evident throughout the deliberations prior to and during the 19th PNC. Moderates in the PLO's dominant Fatah faction—including Mahmoud Abbas (Abu Mazin), Salah Khalaf (Abu Iyad), and Khalid and Hani al-Hasan—urged Arafat to create a provisional or exile government and accept UN Resolution 242 or, at least, declare an independent Palestinian state. The hardliners—including Jamal Muhammad Ghunaym (Abu Mahiri), Fatah Central Committee member, Hayl Abd al-Hamid (Abu Huli), head of Fatah's Central Security Department, George Habash, head of the PFLP, and Nayif Hawatmeh, leader of the DFLP—argued against dramatic changes in PLO policy in the absence of concessions from the United States and Israel. 63

Abu Sharif Statement

A document with conciliatory language issued by Arafat's aide, Bassam Abu Sharif, during the Arab summit meeting in Algiers in June 1988 hinted at a further shift in PLO policy. The innovation in the statement was its implied acceptance of a "two-state solution" for the Palestinian problem. We believe the document—which was not publicly endorsed by Arafat—probably was a tactical maneuver by Arafat designed to impress Western audiences and to test internal PLO reaction. The document eventually helped lay the groundwork for the decisions taken at the 19th PNC meeting in November 1988. 63

As a result of these conflicting positions, political options such as the exile or provisional government were dismissed. Rather, the Executive Committee was empowered to perform the tasks of a provisional government until one is formed at an unspecified later date. Arafat also decided not to define the borders of the Palestinian state—which presumably would limit Palestinian claims to the West Bank and Gaza Strip—because of opposition from hardliners who object to conceding territory to Israel. The PLO Chairman equivocated on acceptance of UN Resolutions 242 and 338 to make the decision palatable to the hardliners—particularly Habash. Even after the conclusion of the PNC, Habash said publicly that he opposes the decision but will abide by the will of the majority in the interest of unity. He also said pointedly that acceptance of Resolution 242 did not mean recognition of Israel. 63

Outlook

Arafat has moved the PLO's political positions toward greater moderation in recent years to bolster ties to key external patrons and to court new diplomatic support. He is particularly interested in convincing the United States of his readiness to negotiate with Israel in order to open direct US-PLO discussions. But he continues to avoid far-reaching changes in

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PLO policy as he tries to balance all the cross pressures. The decisions taken at the recent National Council meeting in Algiers represent a "lowest common denominator" among PLO moderates and hardliners. b3

Arafat probably can get away with this strategy for the short term, particularly in light of the results of the Israeli election in November. Even the moderates in the PLO camp will be hard pressed to make a case for further changes in PLO policy given the likely advent of a Likud-led government adamantly opposed to peace talks with the PLO. At the same time, Arafat cannot afford to alienate completely the moderate Arab states and the Soviet Union, which are likely to be the PLO's principal sources of support at a future international peace conference. b3

Over the longer haul, Arafat's evident unwillingness or inability to seize the historical moment probably will worsen his relations with the moderate Arab states and the Soviet Union. More importantly, the PLO Chairman's dithering could galvanize new, more autonomous trends in the occupied territories. Growing economic problems in the West Bank and Gaza Strip may further encourage greater local activism independent of the PLO if Arafat fails to advance the interests of Palestinians in the peace process. b3

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Outlook for PLO Forces in Lebanon

Recent developments on the Lebanese political scene offer the Palestine Liberation Organization greater opportunity to flex its military muscle and strengthen its position, particularly in south Lebanon around Sidon. Nevertheless, disarray within the organization and competing interests virtually insure that the military command will lack sufficient cohesion to formulate effective strategy and fully exploit these opportunities.

Difficult Times for PLO Military

Despite pressure by PLO Chairman Arafat on his Lebanon-based commanders to mount anti-Israeli operations in support of the Palestinian uprising in the occupied territories, PLO cross-border attempts have declined since April. We attribute this decrease to three events that hit the PLO command nearly back-to-back and seriously undercut the operational effectiveness and influence in Lebanon of the pro-Arafat Fatah forces—the PLO's strongest constituent organization.

The first event was the assassination on 16 April in Tunisia of the PLO's number-two man, Khalil al-Wazir (Abu Jihad)—a longtime confidant of Arafat apparently by Israeli commandos. The loss of Wazir, the Deputy Military Commander of the PLO, created a serious power vacuum within the organization's upper echelon and was at least indirectly to blame for disrupting the operational component within the military wing.

Wazir was highly respected throughout the organization as an astute tactician, political manipulator, and architect of PLO strategy. He played a significant role in the daily running of operations, which took on increased importance after the intifada erupted in December 1987. As Arafat's right-hand man, Wazir's death was particularly disturbing for the PLO leader who relied on Wazir's cunning and loyalty as a counterweight against other ambitious subordinates.

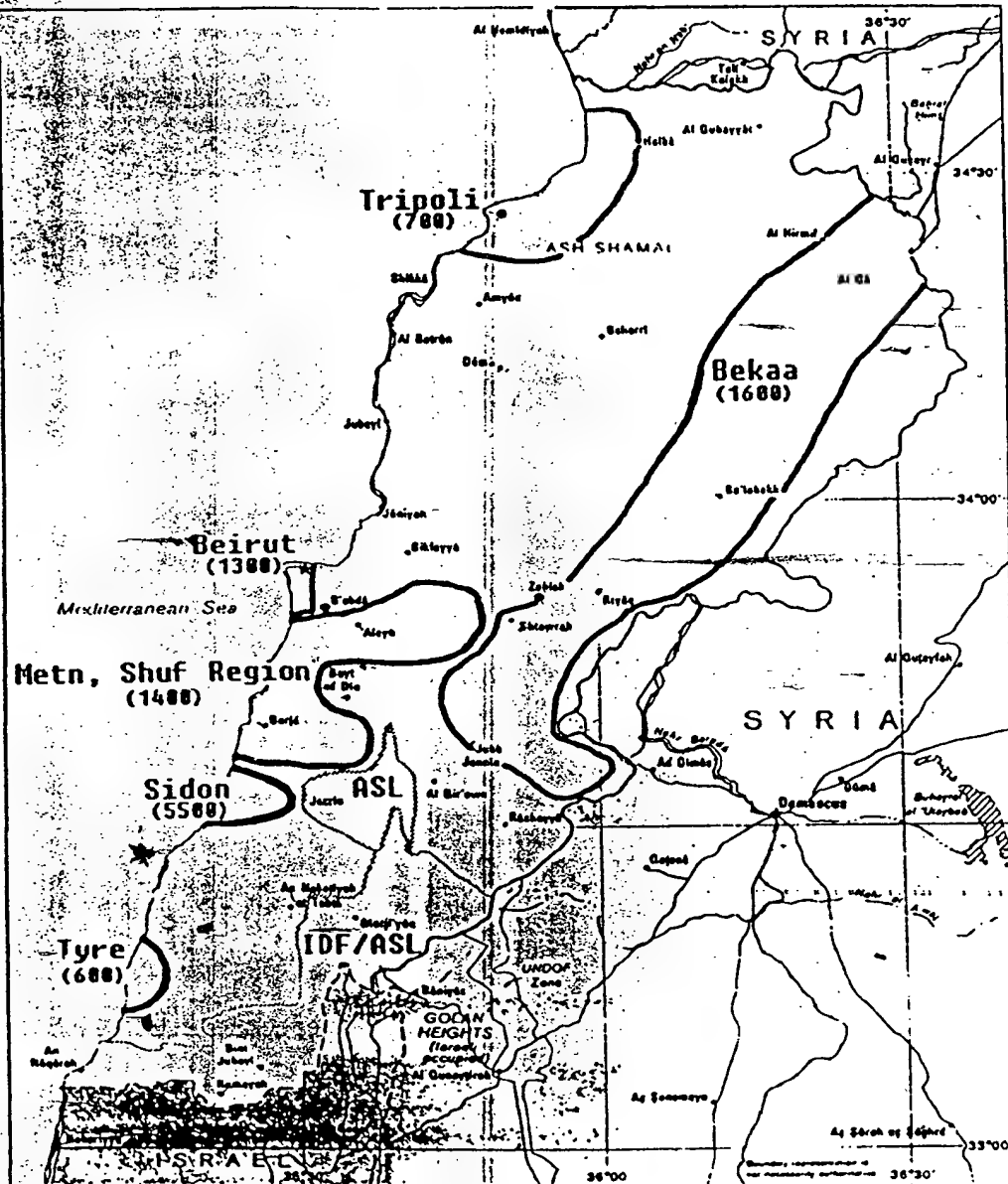
Soon after the assassination, the PLO hierarchy was embroiled in an internal powerplay as senior commanders jockeyed for Wazir's portfolio while Arafat sought to secure his own position by establishing a committee to oversee what had previously been managed by Wazir alone. Hence, the military arm suffered as a significant portion of PLO activity was expended within the organization, leaving day-to-day operations to lower-level, less capable commanders.

The second event was the indirect but destabilizing setback suffered by pro-Arafat forces in Lebanon less than two weeks after the assassination of Wazir. The alliance of these forces with the more radical Shia Hizballah group—responsible for a string of successful anti-Israeli operations in south Lebanon and along Israel's northern border—was dealt a blow by the rival Shia Amal militia. Hizballah was soundly defeated and several of its support centers and staging areas were seized by Amal, leaving them inaccessible to Palestinians embarking on missions aimed at the Israeli security zone in south Lebanon or northern Israel. Fearing that Amal would next lay siege to Palestinian bases in the south, pro-Arafat forces focused their efforts on defending their stronghold in the Sidon refugee camps.

The Amal victory cost the Palestinians leverage in the Lebanese power equation and the skills of a valuable ally. The marriage of convenience with Hizballah had enabled Arafat forces to counter attempts by Amal—stridently anti-PLO and supported by its patron Syria—to limit PLO control and influence in Lebanon. Arafat's fighters had exploited the intense rivalry between the two Shia factions to advance their own interests and undermine Syrian support to anti-Arafat Palestinian dissidents.

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**Palestinian Forces in Lebanon
(approximately 11,000 fighters)**



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Moreover, without Hizballah's crack intelligence gathering and surveillance apparatus and tactical support, the PLO's ability to carry out operations against Israel was substantially limited. Hizballah, for example, often conducted multiple simultaneous harassment attacks on poorly defended positions of the Israeli-backed Army of South Lebanon along the perimeter of the security strip, thus distracting Israeli and Army of South Lebanon troops and allowing PLO fighters to slip undetected into the zone. Between January and March, at least three such operations resulted in Palestinian guerrillas successfully reaching Israel's border and engaging Israeli commandos. b3

The third event was the defeat of Arafat's Fatah forces in factional warfare in the Palestinian refugee camps of West Beirut that reached a fevered pitch in July. Syrian-supported Palestinian dissidents lead by Abu Musa and their Lebanese allies forced Arafat loyalists to surrender the Burj al Barajinah refugee camp—their last stronghold in the Beirut area—and expelled them to Sidon. This defeat was the most serious setback to Arafat's efforts to rebuild the PLO's presence in Lebanon since the 1982 Israeli invasion. b3

It was also a bitter personal loss for Arafat in his feuding with his archnemesis Syrian President Hafez Assad, who has long opposed any independent PLO presence in Lebanon. Arafat's absence from Beirut strengthened Syria's hand in the capital and ability to influence the Lebanese political scene to the detriment of the PLO. b3

Down But Not Out in South Lebanon

Although anti-Israeli operations from Lebanon have declined noticeably since April, both pro-Arafat and dissident Palestinian groups have attempted raids into Israel via other routes. b3

The majority of the foiled infiltration attempts that did emanate from south Lebanon were conducted by pro-Syrian Palestinian and Lebanese factions and directed at the most northern and eastern sectors of the security strip—within easy proximity to their bases in Syrian-controlled areas of the Bekaa valley. Thus, while Arafat's fighters have been laying low in Sidon licking their wounds, other Palestinian factions have been taking up the slack. Such activity has had only limited success, however, compared to the joint PLO-Hizballah campaign earlier this year. b3

Nevertheless, the large number of seasoned Fatah fighters in south Lebanon gives Arafat an ample base from which to regroup and mount limited operations to demonstrate to his detractors that the PLO retains a significant military capability. We believe the influx of Arafat fighters from West Beirut has swelled Fatah's presence in Sidon from 2,500 to nearly 4,000. Another 400 PLO guerrillas reside south of Sidon, in the Tyre refugee camps. Additionally, dissident Palestinian forces in the south number just under 2,000. In short, more than half the approximately 11,000 Palestinian fighters—PLO and pro-Syrian—that we estimate are in Lebanon are now ensconced in the south. Almost all are located along the coast between Sidon and Tyre and within easy reach of Israeli air, sea, and land forces—a fact not likely to be lost on officials in Tel Aviv, who remain wary of the PLO's growing presence in the region. b3

Furthermore, the outlook for the PLO seems to have brightened given the muddled attempt to hold the Lebanese presidential election, the assassination of key Amal official Daud Daud, and the near-fatal shooting of Antoine Lahad, commander of the Army of South Lebanon. All of these events are likely to give the PLO and Hizballah a sorely needed morale boost and the incentive to challenge Syrian and Israeli surrogates for greater control of south Lebanon. b3

Implications

The PLO's internal strife is likely to undermine its ability to exploit fully the recent favorable developments that have occurred in Lebanon. Although Palestinian fighters will almost certainly try to resume their joint military alliance with Hizballah

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and continue periodic attempts to conduct raids into northern Israel, such operations are likely to take a backseat to PLO factional fighting. It is doubtful that even the political breakthrough" crafted by Arafat at last month's Palestine National Council meeting in Algiers will lead to any tangible moves toward reconciliation among the rival PLO and Syrian-allied Palestinian dissident forces skirmishing almost daily in Lebanon. ~~6~~ b3

The more conciliatory-sounding platform adopted by the Palestine National Council—particularly the qualified acceptance of UN Resolutions 242 and 338—may fuel further dissension within PLO ranks and inspire additional defections from Arafat's camp. Radical PLO elements, moreover, may attempt more daring operations aimed at tarnishing the PLO's international image and Arafat's credibility—both on the rise since the Council meeting. ~~6~~ b3

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The Druze Militia: Lebanon's Mountain Warriors

The militia of Walid Junblatt's Progressive Socialist Party (PSP), probably the most capable Lebanese Muslim militia, has reemerged as a key military player in Lebanon as a result of the presidential crisis. Backed by Syria and positioned in the Shuf Mountains south of Christian East Beirut, the force will play a prominent role in any military confrontation with the Christians.

The PSP militia withdrew under pressure from West Beirut following Syria's intervention in February 1987. Its absence from West Beirut limited the militia's role as a national player in Lebanon's militia-dominated politics. After the withdrawal, Junblatt concentrated the group's efforts on protecting the Druze homeland.

Although the militia and the political party are predominantly Druze, both include members of other sects. The PSP's stronghold is in the Iqlim al Kharrub, Shuf, and Mount Lebanon regions.

The Active Militia. No strict chain of command exists in the militia, although Junblatt has delegated responsibilities to subordinates at various echelons in the force's organizational structure.

The allegiance of the PSP and the Druze community to Walid Junblatt, son of the party's founder Kamal Junblatt, is unusually strong. The party militia is not rife with internal divisions like Nabih Barri's Shia Ahmad militia. The only challenge to Junblatt's authority in the Druze community comes from the Arslan clan, but the clan wields virtually no political or military power. For the foreseeable future, Junblatt probably will remain secure as head of the Druze and the PSP, especially as long as an outside threat persists against the Druze homeland.

Organization and Command Structure

The militia has both an active duty element, the Popular Army, and a reserve element, the People's Army for Liberation. Junblatt also has controlled the predominantly Druze 11th Brigade of the Lebanese Armed Forces since 1984. In addition, every man and probably woman within the homeland is armed and will fight if their village is threatened.

Emphasis on Training

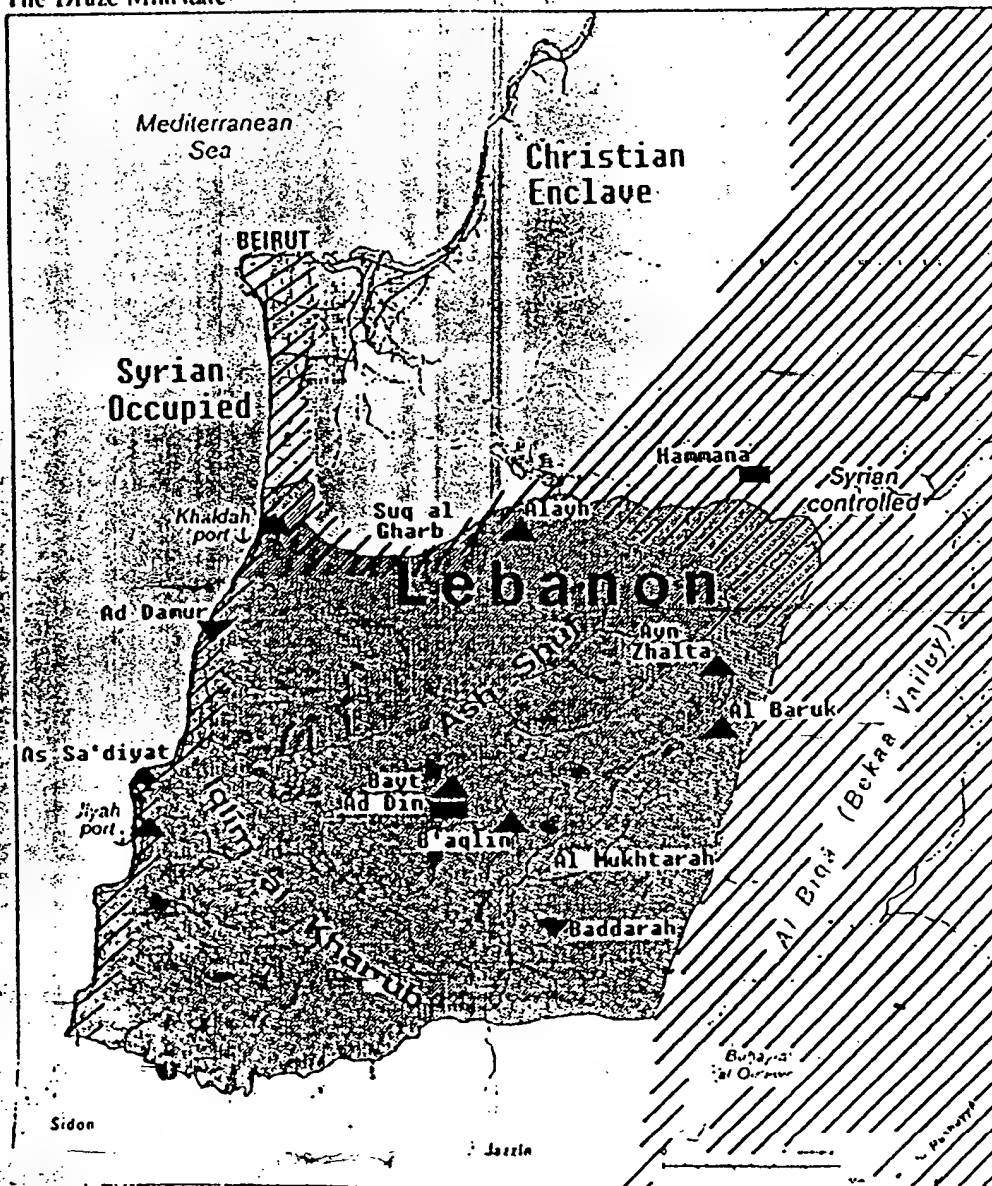
The Druze have a reputation for being the fiercest of Lebanon's warriors and the PSP militia is probably the best trained of the several Muslim militia groups in Lebanon.

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The Druze Ministate



- ▲ militia garrisons and training areas
- ▼ air strip
- 11th Bde garrison

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The Lebanese Army's 11th Brigade

The Lebanese Army's 11th Brigade is one of three Army units that will form the nucleus of the National Army of the Huss government headed by Brig. Gen. Sami Khatib. The brigade's mission is protection of the Druze homeland—the Shuf. The brigade was created in 1984 by several disgruntled Druze Army officers from other brigades and is responsive to Junblatt. Lebanese Armed Forces General Headquarters in East Beirut considers the 11th Brigade an independent unit and is responsible only for the pay, spare parts, and routine administration of the unit.

The brigade's structure is similar to other Army brigades and consists of three mechanized infantry battalions, an armor battalion, an artillery battalion, and a logistics battalion. The brigade is equipped with only three M-113 armored personnel carriers and no tanks. Garrisons for the 11th Brigade are at Hammana and Beyt ed-Din.

The brigade has approximately 1,300 soldiers, who are also members of the PSP militia.

The majority of these soldiers, however, do not show up for duty on a regular basis. The poor Lebanese economy in 1987 forced many of them to seek work elsewhere in order to feed their families.

Equipment

The PSP militia is equipped primarily with Soviet equipment supplied by Syria, Libya, the USSR, and the Palestinians.

the Soviet Union was the main supplier of the PSP but that much of the equipment obtained from the Soviets was in disrepair.

the Soviets cut off all spare parts to his militia. none of his tanks or armored personnel carriers were operational, a claim we believe is exaggerated since some of the equipment has been observed to be functioning since June. Junblatt may have wanted to downplay his Soviet ties.

Balancing Relations

The Christians. Druze-Christian antipathy runs deep and the Druze have vivid memories of the time in 1982 and 1983 when Christian Lebanese Forces militiamen entered Druze villages and massacred inhabitants. The PSP historically has opposed the Maronite Phalange Party, which controls the area to the north of Beirut. Relations between the Christian

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brigades of the Lebanese Army and the PSP militia are tense, with firefights often breaking out along the Suq Al Gharb, centered on a PSP-controlled hill that dominates the surrounding terrain. The Army units in the area regularly receive sniper fire from the hill. Both sides have been improving their defensive positions since the crisis over the presidential election began on September 6.

financial. Although a frequent and sincere critic of Israel, Junblatt benefits from a quiet southern flank created by the Israeli and ASI presence. The ASI pays relatively well and some of the money earned by the fighters probably enters the Druze enclave and helps shore up the local economy. The cooperation also allows him to keep an open channel to the southern Druze communities.

In contrast to his poor relations with the Christians to the north, Junblatt has good relations with the mostly Christian Israeli-backed Army of South Lebanon (ASL) to the south of the Druze homeland. He has allowed some of his followers to join the ASI and, according to the Israelis, the Druze participate in operations of the militia group. Junblatt's motives in this cooperation probably are both tactical and

The Shias. Tensions and distrust remain high between Amal and the PSP, despite the current political alliance between Nabih Barri and Junblatt within the Salim al-Huss government. The two groups became foes in late 1986, when the PSP supported the pro-Arafat Palestinians in their struggle in West Beirut.

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Palestinians. Junblatt has close ties to the Palestinians. The Palestinians operate several camps within the Druze enclave and Junblatt allows them to move about freely as they battle against both the Amal militia around Sidon and in the south and against the Israelis and ASL in the security zone.

Relations With Syria

The PSP's relations with Damascus are shaky. Junblatt does not trust Damascus and is unwilling to fully support its policy in Lebanon, yet he is careful not to totally alienate Damascus. The Syrians consider Junblatt fickle and on various occasions rumors have circulated that Syria is plotting to assassinate the Druze leader. Walid remains paranoid of future assassination attempts and Damascus does not hesitate to remind him of his father's fate.

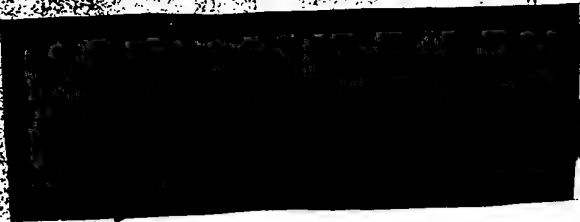

against Syrian-supported Palestinians and Amal militiamen. The Syrians entered West Beirut in February 1987 to shore up their Amal allies and help Amal oust the PSP militia from West Beirut, thus weakening Junblatt politically in the national arena.

The PSP's relations with Hizballah are also mercurial. Hizballah undoubtedly embarrassed Junblatt in January 1987 by kidnaping Anglican envoy Terry Waite, who was under Junblatt's protection.


The Sunnis. The PSP also maintains a relationship with the Sunni Popular Nasserite Organization (PNO) based in Sidon.

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 *The Libyans.* Junblatt also maintains close ties to Libya. 

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 In October after serving a year in Libya and after the cease-fire between Libya and Chad, the last contingent of fighters—approximately 700—returned to Lebanon.

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Relations With Others

The Soviets. Junblatt's relations with the Soviet Union, although still strong, have apparently deteriorated 


 The PSP received a shipment of ammunition from Libya in October. 

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Outlook

We believe that the PSP militia will continue to play a significant role in Lebanon's 13-year-old civil war. Should a full-scale conflict break out with the Christians as a result of the presidential crisis, the PSP militia is certain to be the lead actor on the Muslim side as one of Syria's principal surrogates. The PSP is the only Muslim militia fully capable of launching a ground attack on East Beirut and the Metn, but Junblatt probably realizes, like the Syrians, the costs are extremely high and prefers a political solution to the crisis. 

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Politically, Junblatt will expect to continue to court the internal and external players in Lebanon in order to preserve the Druze enclave. His apparent decision, however, not to return the PSP to West Beirut will limit his political options on the national scene. 

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**Lebanon: Close Call for the
Army of South Lebanon's
Commander (C NF) b3**

The Israeli-supported Army of South Lebanon (ASL), an increasingly significant player in south Lebanon, almost lost its leader Gen. Antoine Lahad in an assassination attempt on 7 November. The attempt on Lahad's life follows a series of destabilizing events in south Lebanon this fall including a car bomb explosion in October by the radical Shia Hizballah group and the assassination in September of two key southern Amal leaders in Beirut, probably also perpetrated by Hizballah.

More Violence in the Security Zone

The attack against General Lahad was the second spectacular attack to occur within the security zone this fall. On 19 October a car bomb exploded at the Metulla crossing into Israel, killing seven Israeli soldiers.

Near-Fatal Attraction

Lahad was shot by Souha Fawaz Bechara, a member of the Lebanese Communist Party (LCP).

General Lahad's absence may also encourage Hizballah and other groups to increase their level of attacks against the ASL within the security zone.

Although initial accounts said Lahad was not seriously wounded,

one of the small caliber bullets cut a carotid artery in his upper torso. He reportedly lost a great deal of blood before his condition was stabilized. Lahad was sent to an Israeli hospital in Haifa where his condition is said to be improving. The time required for a complete recovery remains unclear.

The LCP has long been active in fighting the Israeli presence in south Lebanon, although other groups have been more prominent recently.

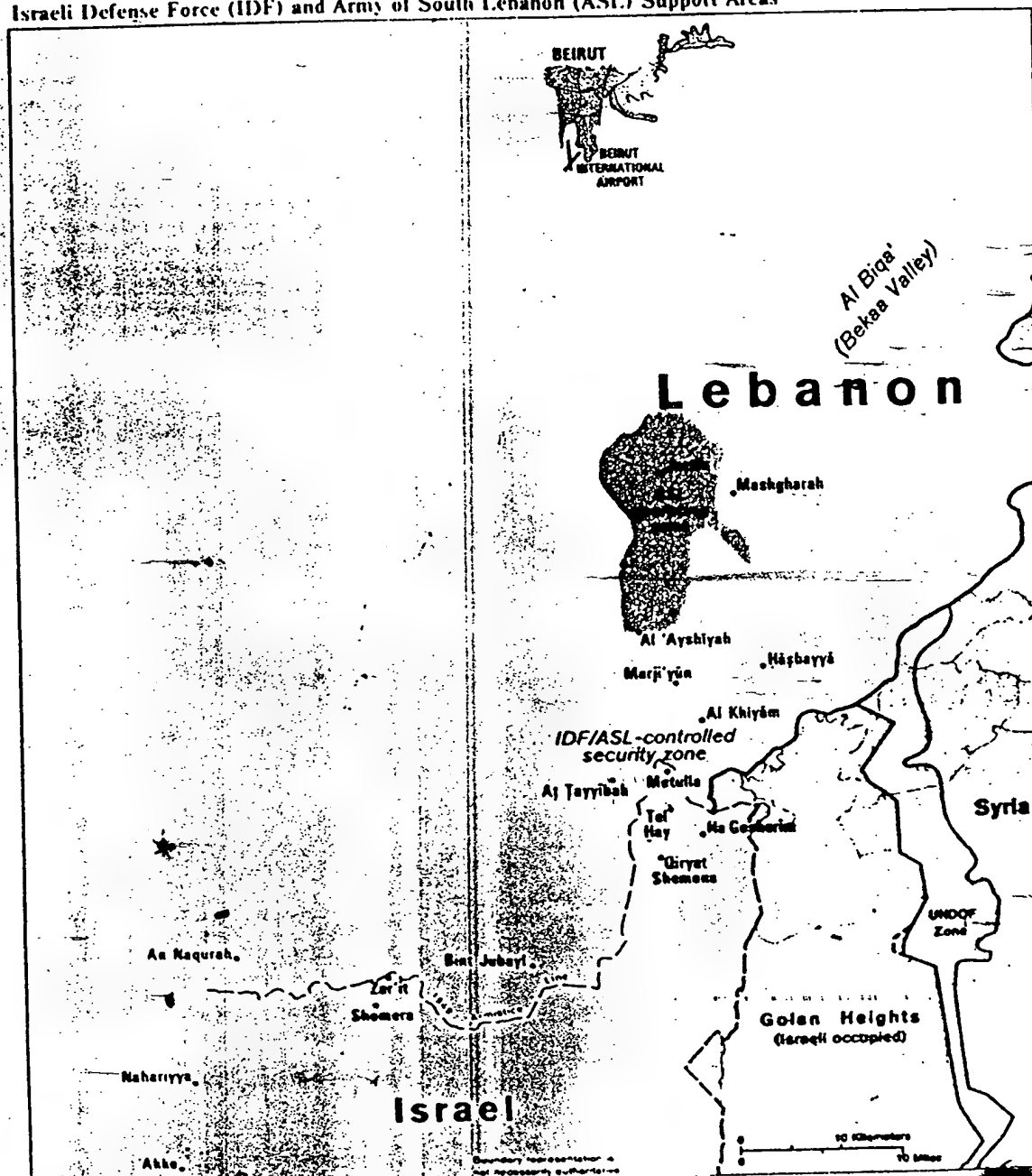
Shortly after the shooting the LCP claimed responsibility for the assassination attempt. The party also sent a deferential public cable to Damascus saying it was President Assad's example of "steadfast" leadership that inspired the attack. The message was sent on behalf of the Resistance Front Command at the request of the "Martyr Lula Abbud Group."

Syria has long had ties to the LCP, which Damascus sees as a "progressive" force in Lebanon. Damascus probably encouraged the LCP to find ways to attack the ASI.

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Israeli Defense Force (IDF) and Army of South Lebanon (ASL) Support Areas



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The Army of South Lebanon

The ASL advertises that its primary mission is to guard the Christian areas of south Lebanon, but its major task in practice is to protect Israel's northern border by patrolling the Israeli-proclaimed security zone. We believe General Lahad has personal political ambitions as well and wants the ASL to achieve a powerful position in Lebanese politics.

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Just one day before he was shot, however, three pro-Syrian Palestinians from the Saiqa group were killed in the western part of the security zone while trying to infiltrate Israel. b3

ASL Still Operating

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The ASL also occupies an area outside the security zone, around the largest Christian town in southern Lebanon, Jazzin, that was controlled by Syria before the 1982 Israeli invasion. Lahad takes a personal interest in Jazzin because it is a symbol of his Lebanese political ambitions. If Lahad cannot return to duty, Jazzin could be more vulnerable than in the past to Lebanese political intrigues. b3

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If Lahad cannot resume his duties, Tel Aviv will undoubtedly anoint a successor, just as it chose Lahad after the death of the founder of the force, General Haddad. Lahad's current deputy, Aqil Hashem, has only served for six months and [REDACTED]

[REDACTED] may not be up to the task. [REDACTED]

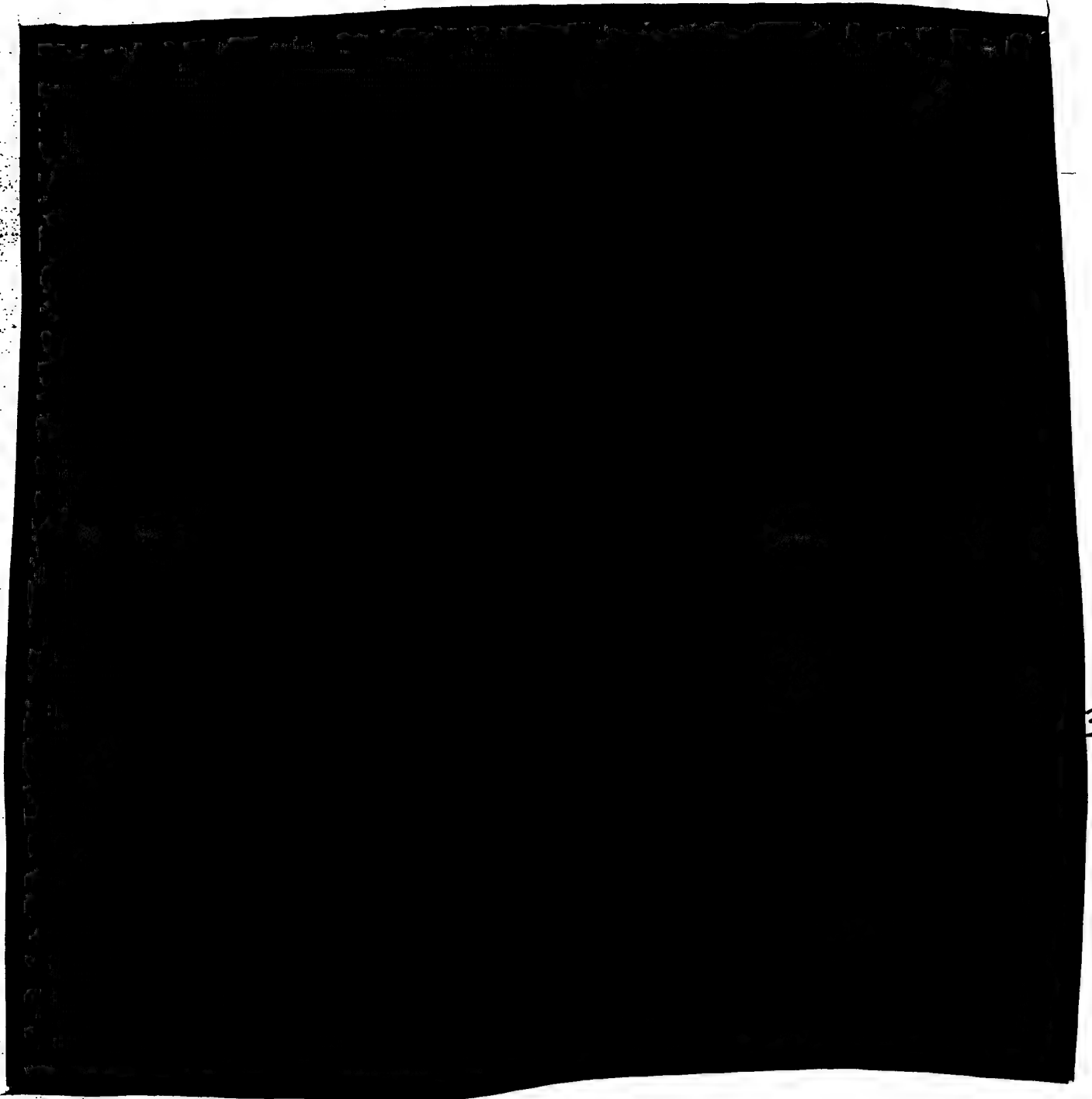
B3 Lahad provides the ASL with a small degree of political legitimacy in the Lebanese system. He was a prominent Christian officer in Beirut before he took over the ASL. He has been an occasional visitor to Christian East Beirut in the last few years and gives the Israeli-linked ASL some Lebanese "cover." He is closely connected to Christian leaders in Beirut such as Dany Chamoun and to the Lebanese Forces militia. We do not believe any of his subordinates have similar political clout. Unless another senior Christian could be found, Lahad's successor would likely be a weaker figure, less able to command respect in the south. [REDACTED] b(3)

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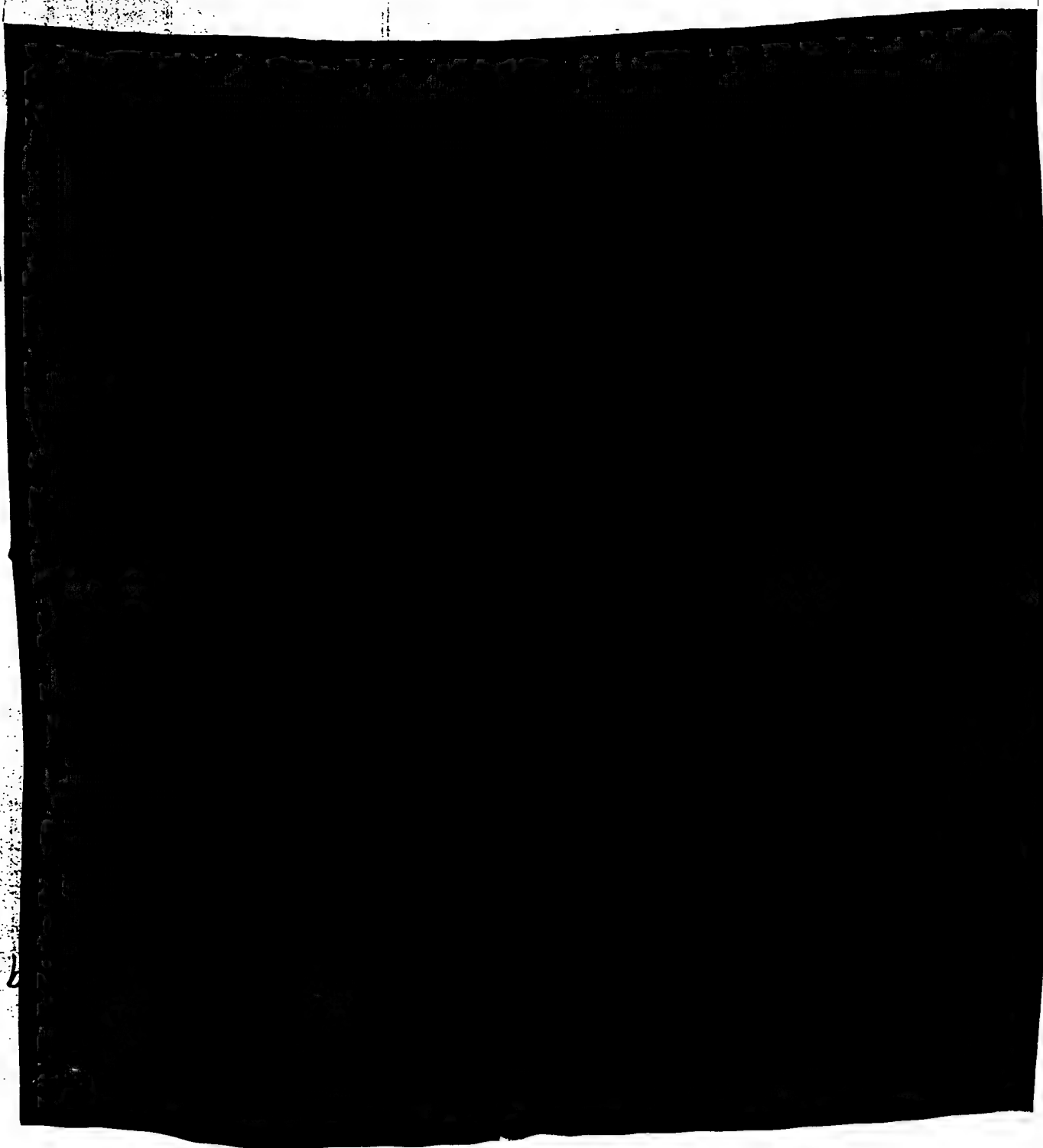
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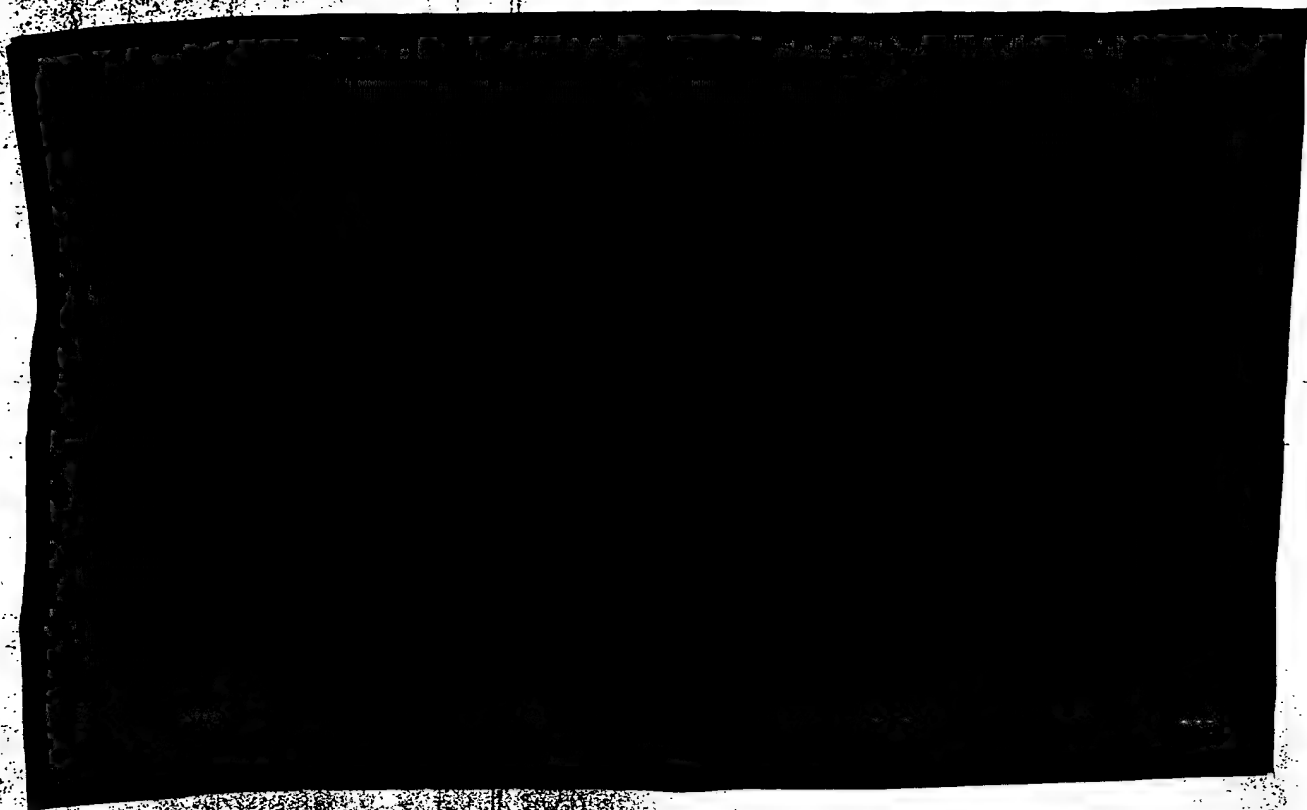
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Algeria: Harsh Environment for Economic Reform

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The outlook for the Algerian economy—already suffering from weak oil prices and a locust threat to agriculture—has become bleaker since the widespread civil unrest of early October. Gross domestic product growth remains stagnant and Algiers is now forced to draw down dwindling foreign exchange reserves to boost imports of much needed food and manufacturing inputs. President Bendjedid's new Cabinet is moving ahead with its economic reform agenda despite opposition from a rejuvenated National Assembly. Plans to privatize industry and woo foreign investors could—if implemented—greatly reduce the role of the state in the economy but will do little to address social and economic problems caused by Algeria's population explosion. Labor unrest will continue to threaten disruption of major economic activities in the months ahead. Algiers prefers to rely heavily on foreign loans but it probably will be forced to begin talks with the International Monetary Fund (IMF) for a standby arrangement if oil prices do not rise and commercial banks balk at new lending.

Bad Luck and Poor Choices

Plunging oil and gas prices over the past two years combined with the mismanagement of Algeria's highly centralized economy have brought the nation to its most serious social and economic crisis since independence from France in 1962. The government squandered revenues from an oil bonanza on Soviet-style heavy industries that today produce low-quality steel and high-priced refrigerators. Botched collective farming turned a once prosperous agricultural nation into an importer of more than half its food. Economic reforms begun last year—including greater autonomy for state enterprises and privatization of the agriculture sector—have yet to turn the economy around. Indeed, just as the government returned most farm land to private hands, drought and locusts struck. The resulting surge in food prices and shortages of water and consumer goods galvanized the public, already angered by falling real wages and increasing corruption among Algeria's elite. Nationwide riots rocked the country in early October leaving hundreds dead and causing \$220 million in damage.

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Bendjedid responded quickly to the rioters' demands, offering limited political reform and promises of a more open economy.

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The End of the Gusher

The riots in October and Algiers' current balance-of-payments problems stem largely from the collapse in 1986 of oil and gas prices—which provide 97 percent of foreign exchange earnings and most of the government's revenues. Oil and gas revenues plunged from \$13 billion in 1986 to \$8 billion in 1988. Specifically, receipts from oil exports are down about one-third from 1985 levels to an estimated \$6.3 billion while gas revenues have fallen nearly 50 percent to \$1.6 billion. To rein in a ballooning current account deficit in 1986, the government cut public investment, dipped into foreign exchange reserves, and slashed imports—creating shortages of consumer commodities and manufacturing inputs. Although the current account has improved since 1986, the forecast this year is less optimistic:

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- Worsening terms of trade—low oil prices, higher grain prices, and increased grain imports—will reduce the trade surplus 9 percent to \$2 billion in the most optimistic assessment.
- The nonmerchandise trade deficit—caused by high interest payments to foreign creditors and other transfers of money abroad—might show slight improvement because of draconian measures to cut foreign consultant services and reductions in foreign exchange allocations to Algerians traveling abroad.

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We expect the current account to post a \$402 million deficit in 1988 unless Algiers settles a longstanding, roughly \$400 million dispute with European customers over the price of liquefied natural gas, which is not likely before yearend. Moreover, we believe yearend foreign exchange reserves will fall at

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least \$350 million to \$1.25 billion as the government restocks shelves and purchases sorely needed manufacturing inputs. b3

In addition, we do not expect any improvement in the domestic economy this year. b3 projects no growth in gross domestic product largely because of the drought and slow gains in industry. Supply shortages, more flexible pricing of agricultural and consumer goods, and faster devaluation of the currency have fueled inflation. b3 it is currently at 11 percent, but we believe it is substantially higher. To head off further unrest, Algiers likely will keep food subsidies in place and increase wages, which will offset small gains on the budget deficit made through improved tax collection. The high inflation rate indicates that interest rates will remain significantly negative in real terms despite plans for a 2- to 3-percent increase in December, giving Algerians little incentive to save and hindering efforts to develop local money and capital markets. b3

Promises of Economic Reform

The far-reaching economic reforms Bendjedid promised in the wake of the recent unrest, if fully implemented, would amount to a major reorientation of the economy. b3

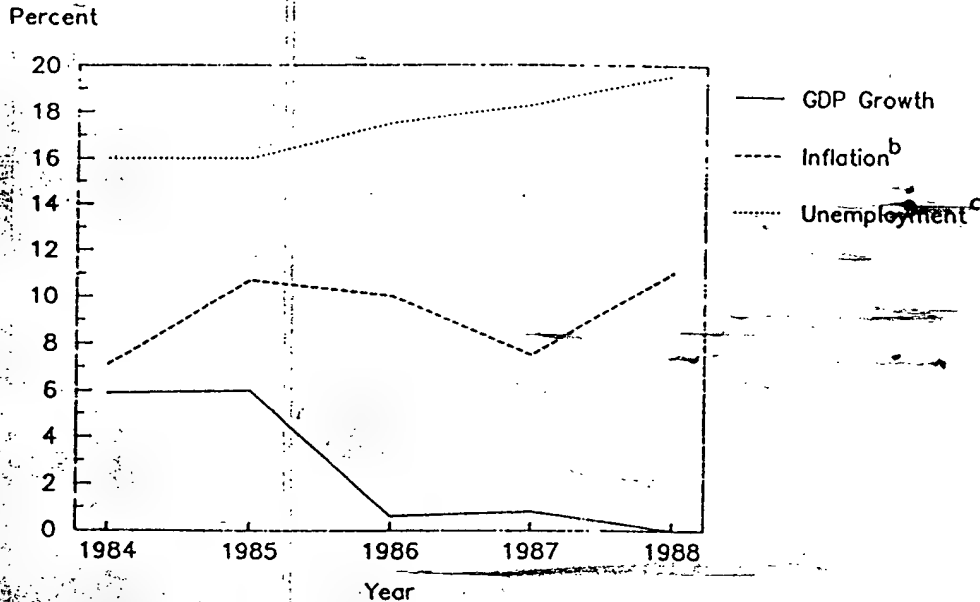
elements in the reform strategy include boosting exports of nonhydrocarbons—which totaled only about \$500 million last year, much of that in goods sent to the Eastern bloc in countertrade deals—and increasing agricultural output. In addition, Algiers hopes to increase productivity and create new jobs by reducing state control of the economy, stimulating the private sector, and encouraging direct foreign investment. For example:

- Much of the public sector—with the exception of the energy and mining industries—will be privatized, according to the government. Algiers has yet to ensure adequate, competitive financing for private firms, which in the past have been crippled by difficult access to bank credits and foreign currency.
- Algiers also plans to relax the government's monopoly over imports and reduce excessively high taxes and tariffs. The existing tax structure forces most private businessmen into black market transactions and takes away profit incentives from managers of state companies.

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ALGERIA: ECONOMIC INDICATORS 1984-88^a



^a 1988 projections

^b [REDACTED] We believe
inflation is at least 20 percent in urban areas.

^c The real unemployment rate also is much
higher [REDACTED]

b1, b3

b3

- The long neglected tourist sector has been opened to foreign investors interested in joint ventures and
- Algiers indicated other sectors will be open to foreigners in early 1989. But the government still must reduce much red tape, reverse its negative image among foreign tourists, and develop a proinvestor attitude to court foreign businessmen.

b3

Although these reforms could reduce the role of the state in the economy, they will do little in the short term to solve structural problems caused by Algeria's demographic crisis. The country's population of about 24 million is third largest among Arab states and is growing at an annual rate of 3.1 percent, one of the highest rates in the world. We estimate that Algiers

needs to build schools for 1,000 children each week for the next decade because 57 percent of the population is under the age of 20. Moreover, the country is creating only a sixth of the housing units and generating no more than a fourth of the jobs needed to keep pace. Although new Prime Minister Merbah said that job creation is a top priority of the new government, state companies almost certainly will be forced to trim their bloated bureaucracy as reform efforts get under way. We believe the government would be well served by reforming the educational system that produces thousands of bureaucrats and doctors but few plumbers and agricultural specialists.

b3

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Uneasy Labor Peace

Workers in the major industrial zone at Arzew returned to their jobs in mid-November, but labor unrest likely will be a problem at Arzew for some time. [REDACTED]

(b)(3) At least 80 percent of the zone's work force went on strike last month protesting low wages and incompetent and corrupt management. Oil refinery workers, who started the strikes on 5 November, returned to work after newly appointed Energy Minister Boussena personally fired the refinery director. [REDACTED]

(b)(3) Although labor problems were thwarted at liquified natural gas plants thanks to management promises to address grievances before yearend - one facility was closed when dockworkers walked out on 18 and 19

(b)(3) November [REDACTED] estimates that the strikes cost Algiers \$10 million per day or roughly \$140 million. Although most worker grievances have been deferred, not met, Boussena's sacking of the notoriously incompetent refinery director illustrates that the new Cabinet can meet difficult strike demands when justified and necessary to smooth industrial relations. Nonetheless, we believe labor unrest will be a key problem for the government in the months ahead. [REDACTED] (b)(3)

Staying Afloat

Algiers probably will rely on Arab largess and support from industrialized countries until unrest is contained and economic reforms start to show results:

(b)(1) (b)(3) [REDACTED]

(b)(3) Morocco continues to send 50 to 60 trucks of food to Algeria per day [REDACTED] in part as a goodwill gesture but also for profit.

(b)(1) (b)(3) [REDACTED]

(b)(1) (b)(3) [REDACTED]

[REDACTED] Algiers still has access to \$150 million from its aid agreement in 1987 with Italy [REDACTED] (b)(3)

Even with considerable support from abroad, Algiers may be forced to tap commercial markets or sell some of its estimated \$2 billion in gold reserves if oil prices remain stagnant. However, wary creditors are demanding higher interest rates on loans, and gold sales would be ill timed given recent weakening of the international gold market. [REDACTED] (b)(3)

In our judgment, a foreign debt rescheduling linked to an IMF standby arrangement would be a bitter pill for Algeria's nationalistic leaders to swallow but would ease Algeria's financing problems.

(b)(1) (b)(3)

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b1, b3

The government has implemented some policies similar to those the IMF recommends—such as cutting imports and privatizing agriculture—but it has not had access to IMF funds or the debt relief options that typically follow an IMF accord. Such an agreement also would bolster the confidence of the large expatriate population, possibly leading to greater domestic investment by Algerians in Europe who would hope to profit from the more open economy. Moreover, rescheduling of some of the country's \$3.6 billion in commercial repayments this year would free up funds to support the economic reform program. For the first time, Algerian officials

are hinting about negotiating some type of program with the Fund, but they almost certainly will await political calm before making such a radical change in debt policy. ~~REDACTED~~ b3

Prospects for Change

We believe the success of President Bendjedid's economic liberalization program depends on the country's quick acceptance of political reforms. A more open economy cannot flourish under Algeria's stifled political system. Bendjedid appointed reform-minded technocrats to his new Cabinet, but he will

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b1/b3
have difficulty purging the sole legal party, the National Liberation Front, and reducing its pervasive influence throughout the country. Leftist party stalwarts believe they will lose their influence and privileges in the political shuffle and that friends and relatives placed in cushy jobs will be laid off by new profit-minded managers.

[REDACTED] We are uncertain whether the new government can overcome party opposition to bring about freer legislative elections early next year. [REDACTED] b3

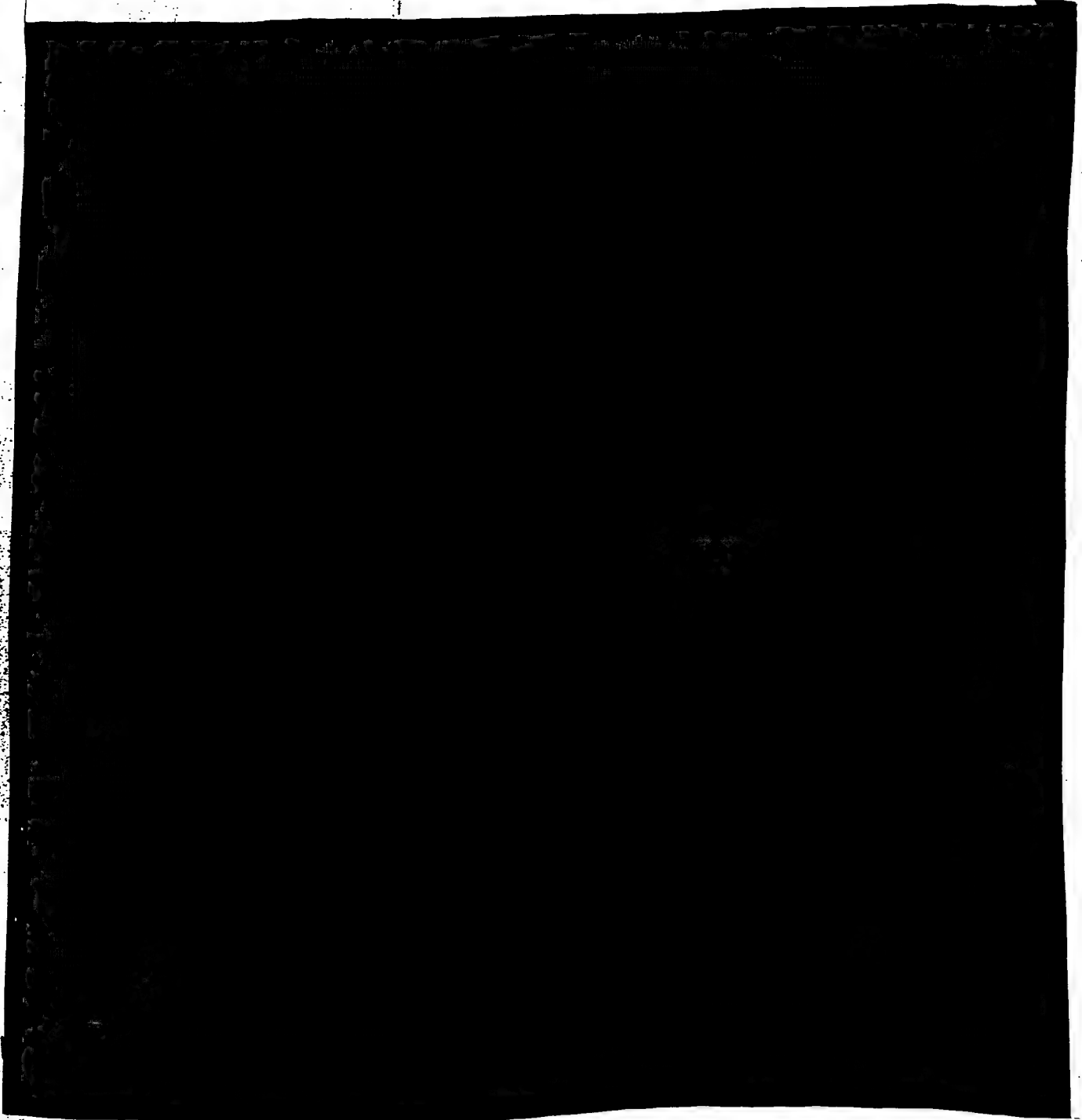
Even with political liberalization, economic growth next year will be limited as the country tries to adjust to a mixed economic system. Attempts to increase nonhydrocarbon exports will be stymied by Algeria's highly overvalued currency—which will keep commodities uncompetitive on international

markets—and pent-up demand from Algerians starved for consumer goods. The newly privatized agriculture sector could show marked improvement next year if weather conditions are favorable and locusts brought under control, possibly reducing the high food import bill. Nonetheless, the key variable will be the price of oil. If OPEC countries stick to their recent production accord, prices could increase to \$15 to \$18 per barrel, which would provide a major boost to the Algerian economy. We believe, however, that prices will remain stagnant, providing no relief for Algiers's financial crunch and the already difficult environment for economic reform. [REDACTED] b3

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6 December 1995

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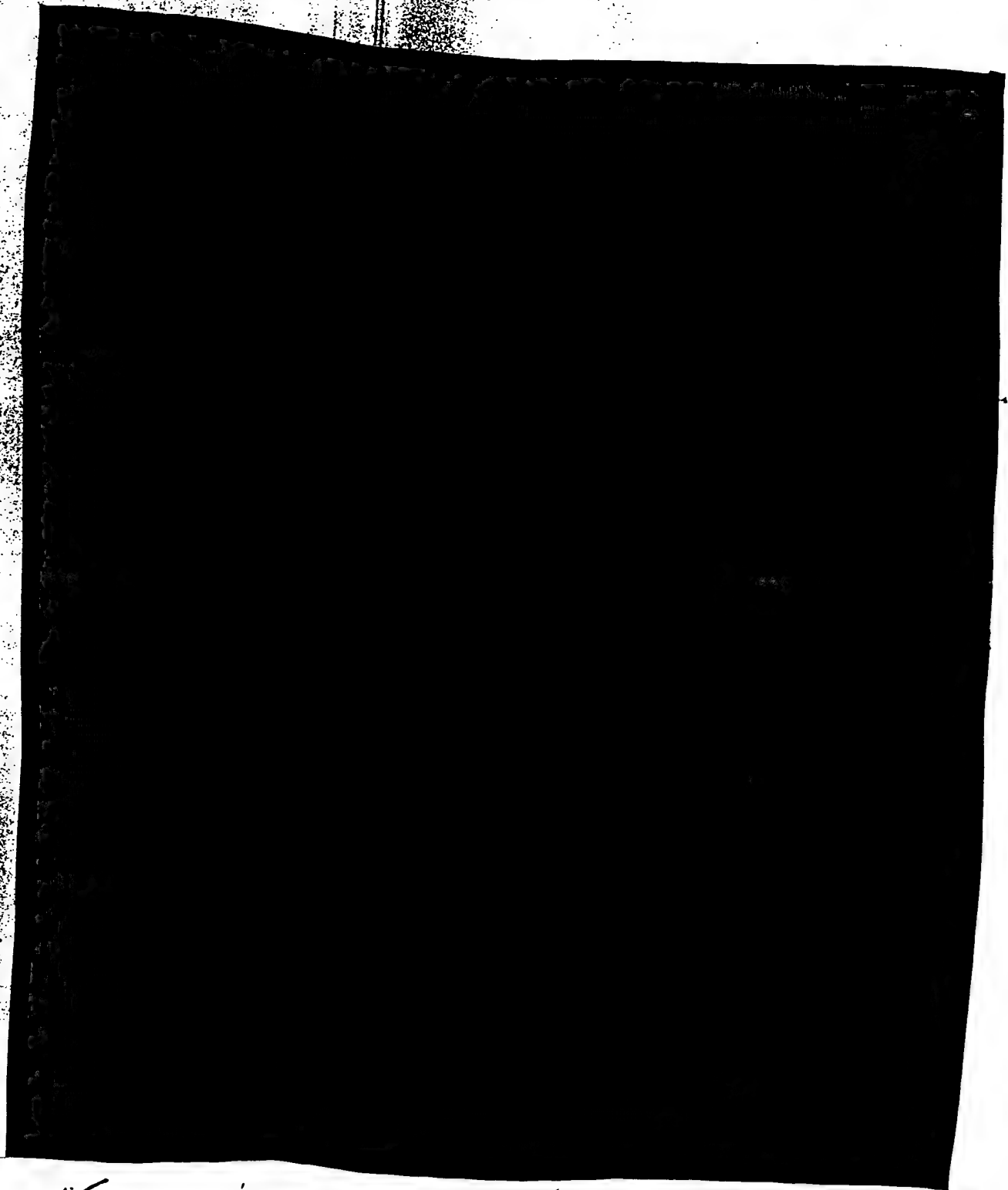
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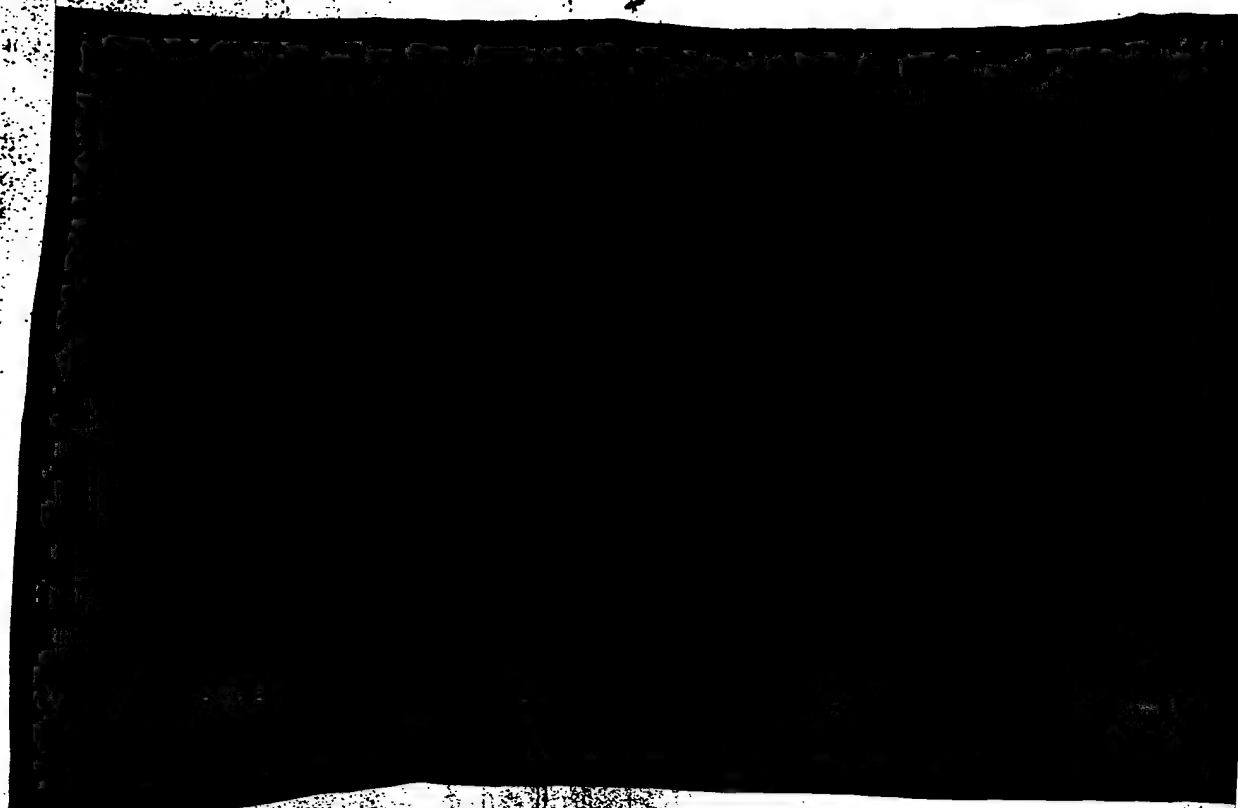
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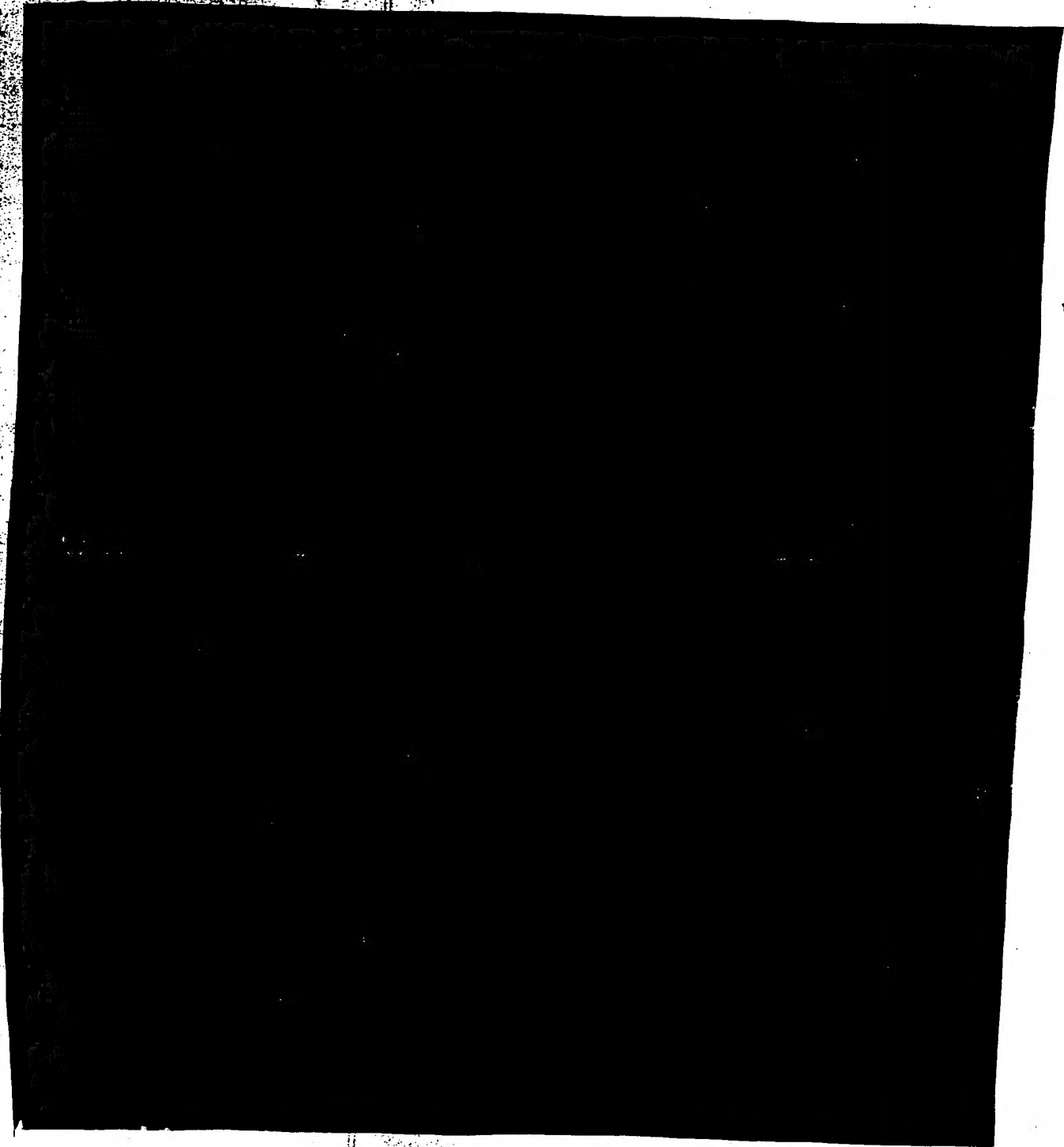


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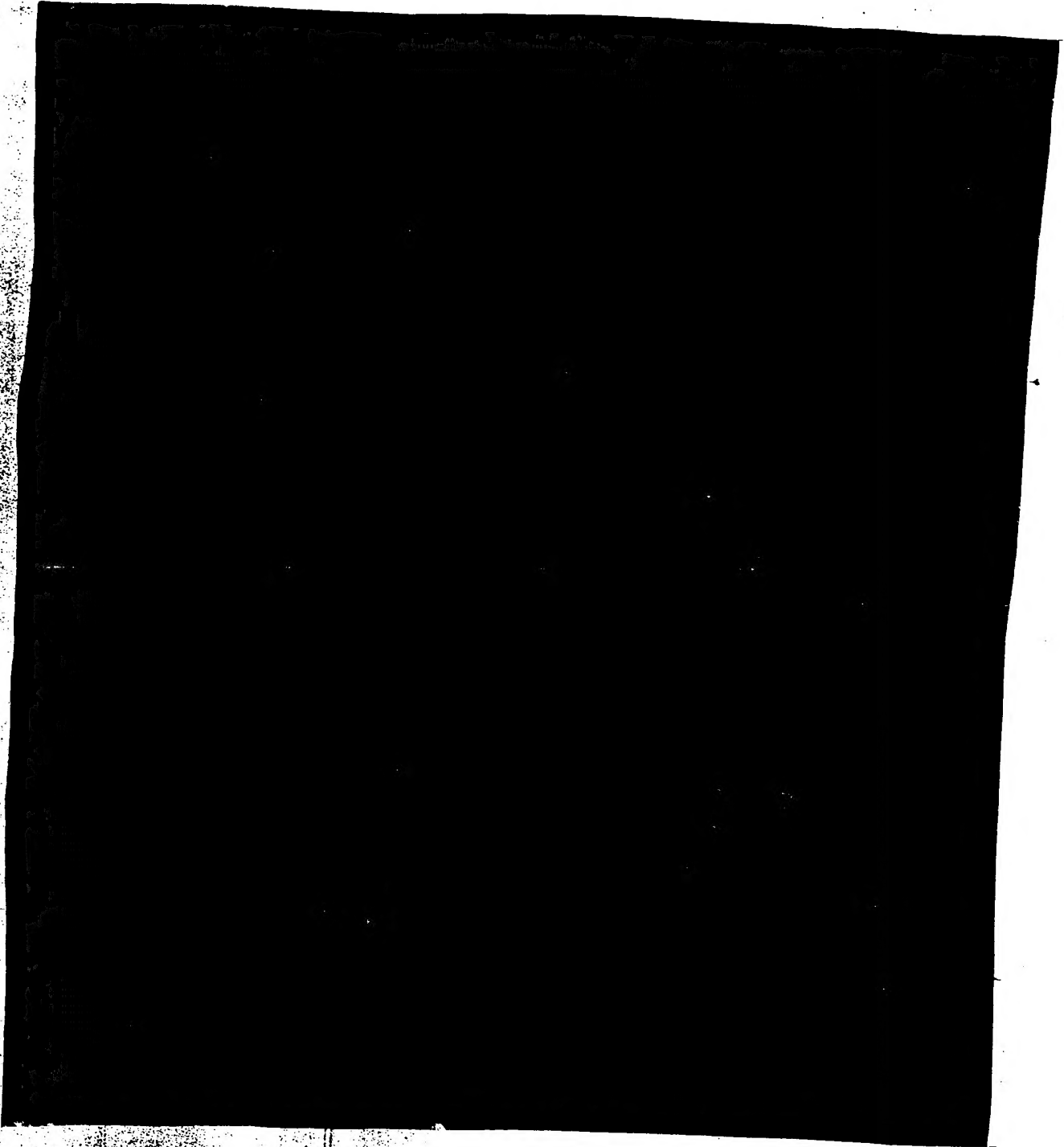


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